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HEARINGS

BEFORE THE

COMMITTEE ON THE BUDGET UNITED STATES SENATE

NINETY-NINTH CONGRESS

FIRST SESSION

ECONOMICS

FEBRUARY 5, 1985 } VIEWS OF THE REAGAN ADMINISTRATION
FEBRUARY 20, 1985 }
FEBRUARY 6, 1985—VIEWS OF THE CONGRESSIONAL BUDGET OFFICE
FEBRUARY 8, 1985—VIEWS OF THE FEDERAL RESERVE SYSTEM
FEBRUARY 21, 1985—VIEWS OF OUTSIDE ECONOMISTS
FEBRUARY 22, 1985—VIEWS OF GROUPS AND ORGANIZATIONS

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VIEWS OF THE REAGAN ADMINISTRATION

TUESDAY, FEBRUARY 5, 1985

U.S. Senate,
Committee on the Budget,
Washington, DC.

The committee met, pursuant to notice, at 10:06 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Armstrong, Boschwitz, Symms, Grassley, Kasten, Quayle, Gorton, Chiles, Hollings, Johnston, Sasser, Hart, Metzenbaum, Riegle, and Exon.

Staff present: Stephen Bell, staff director; and Gail Fosler, chief economist.

For the minority: Richard N. Brandon, staff director; and John Hilley, senior economist.

Chairman Domenici. The committee will come to order.

The photographers here in front, between the Senators and the witness, will have to move around to the side of the table. We do not want people between the witness and the committee members, so if you all will get around to the side there, you can take all the pictures you want. We will give you another few minutes to get out of the way.

[Pause]

Chairman Domenici. All right. We are going to try to use this first hearing as much as possible—and I understand that everyone wants to be heard—for the witness and questions. But I am going to try to change the rules slightly at this first hearing, if everybody will cooperate. After this hearing, we will continue with the old rule The chairman and ranking member will have opening statements, and I will yield to any Senator who has a brief opening statement, if they would like to make one. Then, we will hear the witness, and then each take 5 minutes for questions and/or opening statements. The 5-minute time limit will also apply to the chairman and the ranking member so that we have every opportunity to get around maybe twice with questions today.

Senator Chiles. Mr. Chairman, since this is the opening hearing, I would like to make sure we know the ground rules for statements and questions. We worked out a pretty good agreement last year and it was both flexible, and accommodating.

I have a short opening statement now—I do not know what the other people on our side have—but I want to make sure that people have the same opportunity.

Chairman Domenici. I agree with that, and I just said that. I do think, however, that it is the prerogative of the Chair on opening statements with so many members, and I was really asking that, since you and I will be bound by 5 minutes of questions also, that the members keep the opening statements as brief as possible, and that after this first hearing, we try to not have opening statements, unless it is absolutely urgent. But today, we will be flexible and yield for some brief opening statements, if we can, so that we can get to the witness.

OPENING STATEMENT OF CHAIRMAN DOMENICI

We are pleased to welcome you here today, Mr. Stockman.

The President's 1986 budget was released yesterday, and we are most appreciative of the fact that you are here on the very first day of our fiscal year 1986 budget hearings 1 day after the release of that budget

Before we hear from Mr. Stockman, I hope you will indulge me for just a few moments, and I will try to be very brief. I do want to say to the members of the Committee that I am sure that a number of you from time to time have wondered and worried about our responsibility and our role in this process. I make no bones about it; the ball is in our court. I am not so sure that we all want the ball in our court. I am not sure, with the problems that I see, that I relish having the ball in our court.

But I would like to say to you that I think, while we are few in number, that we have a very, very grave responsibility and a rare opportunity. I will be flexible in terms of a budget resolution. On the other hand, I hope we are all leaning in the same direction of trying to get a very binding resolution. I hope we are already thinking about a maximum amount of reconciliation in it, in order to truly send a message to the people, to the President, and to our fellow Members here in Congress.

PRESIDENT HAS NOT WALKED AWAY FROM BUDGET

I do not think I have to say anything about the nature of these deficits. They are enormously large, our task is extremely difficult, and everyone seems to have a plan to cut the deficits. Now we have the President's plan.

While many of us would not agree with his budget, I do not think he has walked away from the budget. He has simply indicated the way that he would like to reduce the deficit. For those who have not added up the numbers, it amounts to about $239 billion in restraint over the next 3 years.

I have heard all of the other plans discussed. I have tried to review them. And I would say right up front that, while they differ, none of them, with one exception, exceeds or even meets the goals in terms of $239 billion over 3 years and $50 billion for the first year in outlay reductions that are included in the President's document, whether we like it or not.

So I think we ought to start this year with at least one misconception cleared up. Cutting the Federal deficit by $40 to $50 billion in fiscal year 1986 through spending restraint alone will not be easy; it will be extremely difficult.

MARK WILL NOT BE REACHED BY FREEZE

I predict that if we go through the exercise that I have been through over the last month, you will learn that a freeze on budget authority will not reach this mark. Indeed, if you simply take an estimate of an across-the-board freeze in savings, you will find that that amount is anywhere from a low of $12 billion to as high as $25 billion off the mark, depending upon economic assumptions and baselines.

The President apparently went through this exercise, and he made a decision that, since a freeze alone will not do the job, more had to be done. So we have before us the most difficult budget, in my estimation, that any Congress has ever received. The President asks us to end 11 major domestic programs, and make 13 reforms in major programs, expand user fees in 7 areas, and change 8 other domestic programs. These savings add up to $180 billion over fiscal years 1986 through 1988.

We can argue that the President should have frozen defense, we can argue that he should have frozen Social Security, or that he should have included all cost-of-living indexes, even those on SSI and the like. He did not choose to do that. Even if we choose to do that, we will still have to accept some of the things that the President recommends on the domestic side of this budget if we are serious about the goals and the numbers that many of us have spoken of.

It is for this reason that I think this is a year when we have a big responsibility, and we can fish or cut bait. I propose that we truly "fish" and that we do it right. The President gave us his ideas. I believe he is saying to the Congress, "What is your plan? Do you have a better one?" We might have a better one. I think the President has put the ball in our court and asked us to either endorse his approach or devise one that is better or just as good.

DEFENSE INCREASE REQUEST MUST BE RESTRAINED

Now, I do want to say on a personal note, I believe we must restrain the President's defense request. I believe we must not insulate any part of the budget from scrutiny. I am willing to vote for real farm reform that will save money and lead to competitiveness in the world markets. I am willing to vote for a number of the domestic recommendations. That does not mean that all of us are willing, and that does not mean that my way is the only way.

I will say to you I intend to be flexible, and I hope all of us can be flexible in an effort to get a real budget that will reduce the projected deficits. I do not think there is any more long-term problem of significance to the U.S. economy and its people than this. I am also saying that I like the programs that we might have to cut. I like UDAG, I like Amtrak. I believe the deficit is more critical than any one of the programs so, if given a choice, I will vote to terminate many of them if we have the right package, and if it is going to do the job.

On defense, I have to say, Mr. Stockman, that Congress has been extraordinarily generous in the past decade. We have had more than a decade of real growth in outlays for defense. If we give the President the real growth increase he asks for in 1986, we will have doubled the defense numbers in five years. I simply believe that we have enough buffer in our defense spending, and this year we just cannot give the President the defense request that he recommends.

I also must note that the defense spending cut the President proposes is actually an increase of over $30 billion in outlays from the fiscal year 1985 level, and I think even by Washington's standards, a $30 billion outlay increase is not just a little bit; it is quite a lot.

CONGRESS MUST DO BETTER ON DEFICIT REDUCTION

In short, the President has sent us some goals. He has his ideas on deficit reduction, but I believe Congress must do better. And I do not believe we can reach there without taking a look at all of the budget, not just the one-third that the President has recommended in this budget address.

Now that most of the Senators are here, let me close on a note that has to do with committee business. We have Mr. Stockman here today.

Tomorrow at 10 a.m., we are going to have Rudy Penner, Director of the Congressional Budget Office. Then, on Thursday at 9:30 a.m., we will have Secretary of Defense Caspar Weinberger. Finally, on Friday at 9 a.m.—and I mention that because he was very accommodating, and he asked if we would start early—so at 9 a.m., we will have Paul Volcker, Chairman of the Federal Reserve.

I would tell you in advance that Mr. Volcker has not met with the Board of Governors, Senator Chiles—he will not meet with them until a week or 10 days from now—so it will be difficult to discuss future monetary policy in any detail. But he has certainly agreed to appear and lend us his expertise and his wisdom as we begin these deliberations.

The week that we return from the legislative recess, February 19 through 22, will be filled with hearings. You will get the detailed schedule if you have not already. And I am making arrangements to add a couple of other witnesses that a number of you have indicated a desire to have.

We have until April 15 under the budget process to finish our work. I have set, at least tentatively, a schedule that would move us along much faster than that. But it is our normal process to hurry along, and I hope you will all accommodate your schedules to do what I perceive to be the most urgent business of the people. We must get a budget resolution that is binding and effective, and we will do our best to achieve it.

I now yield to Senator Chiles.

OPENING STATEMENT OF SENATOR CHILES

Senator CHILES. Thank you, Mr. Chairman, and good morning, Mr. Stockman. We are glad to have you with us.

It seems to me that we should be as practical as possible this morning and ask ourselves what this year's budget must accomplish. First, it should cut the deficits, and second, it should help us take command of our future. The deficit we have now is enormous, and it has got to be cut. But if we plan wisely for the future, I think we can build a nation as great as we want it to be, and we can do that if we realize we need each other's help, and that we have to work together.

PRESIDENT'S BUDGET IS A STARTING PLACE

This budget has room for improvement. It is a place to start, since it brings the President onboard as a believer in the ideas that runaway deficits could strangle our economy. If we use the President's budget as a starting place, we may be able to get some genuine deficit reduction. If we take it as the end-product, we will be selling ourselves and the public short.

Today, making a living is a real struggle for many people. In rural America, for example, people are trying to save their farms and their businesses and their homes. It seems to me it would be a good investment to help those people restore their credit. We have a nation of young people who want to train themselves to master new technology to lead us in the years ahead. On the other hand, we have a growing number of people in this country who are older and planning for retirement and increased health needs.

These people and a great many others do not always look to Washington for help, but they do not expect to be harmed here, either. In some hard ways, the administration's budget will create serious problems for all of those people I have mentioned. At the same time, this budget prescribes the deficits at around $170 billion for years to come.

So what we have is a budget that recognizes the serious need for deficit reduction, but has not found a way to do it fairly and effectively. Congress and the President need to cooperate. And many people will take some pain in this budget. But there are a number of others who get by untouched, and some who will be better off than ever. I think we have got to show people that deficit reduction can be a benefit to all of us, and we can, if we show it leads to lower interest rates and makes durable goods less costly. It will allow us to promote our exports and safeguard American jobs, and a lower deficit can help bring economic stability and let people plan their futures with greater confidence.

It is going to be hard to sell deficit reduction to the American people unless we do it in the fairest way possible. It is going to be hard for the Nation to meet the demands of the future unless we shape this budget with much care and thought.

With the President's budget out before the public, the process has now begun. Mr. Stockman, I know you think we can do better, and I feel the same way. This ought to be the day we begin the process, together, for the sake of the country.

Chairman DOMENICI. Thank you very much, Senator Chiles.

Does any other Senator have an urgent opening statement?

Senator Grassley.

Senator GRASSLEY. As far as the peer pressure to be very short, if you would grab the gavel, and the second I exceed the time that anybody else has taken so far, I will be glad to stop right there.

Chairman DOMENICI. Do you mean anybody else other than the chairman and the ranking member?

Senator GRASSLEY. I meant that I am inviting the chairman, if I go too long, to stop me.

Chairman **Domenici**. Go ahead. We trust you implicitly.

OPENING STATEMENT OF SENATOR GRASSLEY

Senator **Grassley**. Mr. Chairman, many of us on this Committee started here 4 years ago. Each year, both the administration and the Congress have declared war on high deficits. Each year, high deficits have won. And of course, the victories are becoming more and more one-sided in favor of high deficits.

We are losing the war against deficits because we fail to acknowledge the differences between projections and performance. We project numbers on paper and assume they are real. Yet, if reality were as projected, we would have had a $117 billion surplus this past year. That is according to the original fiscal year 1980 estimate for fiscal year 1984.

PROJECTED DEFICITS VERY MUCH UNDERESTIMATED

The first Committee estimate of the fiscal year 1986 deficit made during this administration was a $39 billion surplus. The actual deficit, of course, will be more likely near $200 billion. And of course, that is a difference between projections and reality of $240 billion. This is the clearest possible graphic of our inability to understand the long-term consequences of current budget decisions. The degree to which we tolerate these mismatches is, of course, the degree to which we fail as a committee and as a Congress.

This year, the administration projects cuts of $51 billion for fiscal year 1986, $105 billion for fiscal year 1988. The deficit is projected to decline to $144 billion by fiscal year 1988.

Mr. Chairman, if there is one thing history has taught us it is that the President's budget submissions contain seriously flawed spending and revenue estimates and that projected deficits are therefore very much underestimated.

The first major problem, then, with this budget is that the economic assumptions underlying the President's 5-year budget again test the bounds of reality. There is no empirical basis for the economics assumed in this budget. They are not the product of economic analysis and probability. They are merely the product of a desire to show declining deficits on paper.

Given this fact, the historical pattern of over-optimistic deficit projections will not be broken. In other words, the President's budget submission has once again been preprogrammed for self-destruction.

FREEZE ONLY VIABLE BUDGET OPTION

I am taking the opportunity to release at this time, Mr. Chairman, for the committee—and they are available for anybody who wants them—and for Mr. Stockman, as well, my comprehensive analysis to support empirically the contentions I have just presented. This analysis demonstrates the likelihood that the economics contained in the President's budget are unrealistic, that deficits will undoubtedly be higher in the out-years, and that the target of reducing the deficit as a percentage of GNP to 4, 3, and 2 percent respectively is unattainable, given our reluctance to change our method of business. This analysis I have made available is in the form of report language for the first concurrent resolution on the budget for fiscal year 1986, based on a 1-year, across-the-board freeze. It argues the necessity of a freeze as the only viable budget option.

Thank you.

Chairman **Domenici**. Thank you very much.

Senator Riegle?

OPENING STATEMENT OF SENATOR RIEGLE

Senator **Riegle**. Thank you, Mr. Chairman.

Clearly, we are beginning a long and difficult process today in taking on this budget issue. It is clear that the deficits are too high and that they have to be reduced.

I think the basic question we face here is whether this budget as drafted is good for America and good for the American people. As we begin this budget debate, I think we have to dig deeper than we previously have, to get all of the facts into the open and on the table. We have to make crystal-clear both the stakes and the tradeoffs that are involved, and the American people need to participate directly in this discussion, debate, and decision.

I think we need a spirited national debate and inquiry. The future is truly at stake in the decisions that we are about to make, and the public has to be part of it.

ADMINISTRATION GAVE NO SIGNS OF MASSIVE CUTS

Unfortunately, before the recent national election, there was no sign from the administration that we were facing a budget crisis requiring massive cuts. In fact, the assertion by the administration was that everything was fine, that the deficits were declining. There was no hint of the massive cuts presented today in vital areas of government.

It is obvious that the administration was not honest with the American people before the election. I think the facts have to be put directly on the table for every one of us to see. What we have, in this budget proposal that Mr. Stockman is presenting is a massive continuing shift of resources to the Defense Department. Waste is rampant at the Defense Department, from the $600 toilet seats that we are reading about to overlapping, multibillion dollar nuclear weapon systems that we dare not even use.

It is essential that we put a lid on defense spending, and on the rest of government spending as well.

Senator **Boschwitz**. Is that a $600 "lid"? [Laughter.]

Senator **Riegle**. That is probably a better use for it than where it is being used now.

I think that an across-the-board spending freeze, exempting the Social Security trust fund, which is separately financed and in surplus, as the President has noted, but I think an across-the-board spending freeze may be our best answer for this growing fiscal crisis.

I would like to say again in closing that the American public should be directly involved in this debate and decision. It cannot be one that this committee or the Senate or the Congress alone tries to make. We have our part to play, but the public will carry the weight of the effect of these decisions, and I feel it essential that the public be directly involved.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you, Senator.

Any other Senators?

Yes, Senator Boschwitz.

OPENING STATEMENT OF SENATOR BOSCHWITZ

Senator BOSCHWITZ. Mr. Chairman, I intend to join you in being flexible in this whole process. Only in that way are we going to come to a resolution of it. I also join you in thinking about the maximum amount of reconciliation and not limiting the reconciliation to 1 year.

Frankly, I despair about our chances of making progress in the budget process, because interest rates are coming down, times are pretty good, and there is almost not enough of a crisis. But I nevertheless feel that this is the time to make progress, and I will do whatever is necessary and be extremely flexible in arriving at some type of method of making progress, and indeed, I may support a freeze.

INCLUDE ALL ASPECTS OF BUDGET IN FREEZE

Four years ago, as a matter of fact, I suggested a freeze which would allow a 5-percent increase across-the-board, a slow freeze, so to speak, recognizing that over the course of the last 25 years, government income has risen by 9.7 percent on the average. But that 5 percent slow growth was not adopted, so maybe at this point we just have to have a flat freeze, and I certainly would agree with the chairman that defense has to be included in that. I am not quite sure if the Senator from Michigan said that Social Security should be included, but I would include all aspects of the budget. Otherwise, we will not be able to achieve the end.

Let me say, Mr. Stockman, I believe that you have been Director of the Budget longer than any of your predecessors, as I recall, and I hope very frankly that you will stay on a good long time, because I admire your competence in the job. I have never met anybody who knows so much about so many Federal programs and knows the intricacies of those Federal programs as well as you do. I sometimes go and talk to you—and we do not always agree—but nevertheless, I admire the enormity of your competence. I sometimes go and talk to you about programs in which I am quite well-versed and find that even though they may be somewhat arcane, that you are better versed in them than I.

So I think that if we are going to achieve any type of a balanced approach to the budget that we need to keep you where you are, despite the fact that you sometimes develop arguments with some of us, I must tell you that I greatly admire you and the enormity of the competence you have in the budget process, which I think is unmatched, very frankly.

GOVERNMENT OVERHEAD MUST BE CUT

All of my business experience, Mr. Chairman, tells me that we have just got to knock down the overhead of Government I note over the years that income of Government has increased at about 10 percent a year, 9.7 percent, a little more rapidly during periods of recovery, as we noticed last year, and that we simply have to slow the overhead. I am flexible about how it gets done and I know that reconciliation has to be part of the process. I will go along with many ideas and will impose hardship across-the-board, hopefully, and that is the only way it is going to get done. But with flexibility, reconciliation, and Mr. Chairman, also, with your leadership in this process, I think we can get something done.

Chairman DOMENICI. Thank you very much.

Mr. Stockman, if you have a prepared statement, it will be made a part of the record.[1] If you can summarize it, I would appreciate it.

Let me tell the Senators the order of their arrival. On the Republican side: Grassley, Kasten, Symms, Boschwitz, Armstrong, and Gorton; and for the Democrats: Chiles, Metzenbaum, Johnson, Riegle, Hollings, Sasser, and Hart. We will proceed after Director Stockman with the Senators in that order.

Mr. Stockman?

STATEMENT OF HON. DAVID A. STOCKMAN, DIRECTOR, OFFICE OF MANAGEMENT AND BUDGET

Mr. STOCKMAN. Thank you, Mr. Chairman and members of the committee.

It is obvious to say at the start that we are confronted with a monumental fiscal problem, and that it is true, finally, that the time of reckoning has come, and we can no longer avoid the difficult and challenging task of putting our fiscal house in order if we want to avoid running our national economy into the ditch in the years ahead.

I think every member of this committee knows that this day and this time has been coming. I think everybody recognizes that we have a very short or brief time to get the job done.

In the cycle of our political system, we probably have about 6 months to work it through, to come to conclusions, and to take decisive action.

BUDGET HAS NO SINGLE CAUSE FOR GIGANTIC IMBALANCE

I can only say, as one of your colleagues who has labored in the vineyard of this budgetmaking business, that this challenge that we face will tax the abilities of everyone beyond measure, simply because there is no single cause for the gigantic imbalance in our budget that we now face; only a long history, both recent and distant, of things done and things not done that cumulate to the dimensions of the problem that we have today.

I do not have to tell members of this committee that we are dealing in a context of staggering complexity. We now have a budget that is $1 trillion in its dimensions, that is a blooming, buzzing mass of programs, projects, commitments, purposes, responses to needs in our society of every kind, that is bolstered with claims and counterclaims that are most difficult to sort out when you deal with them one at a time and that, as the members of this committee know, more often than not is obscured by accounting complexities that defy comprehension as we begin to argue about the numbers, the choices, and the cuts.

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[1] See p. 26.

So I would like to ask the courtesy of this committee this morning for about a half hour to go through in some detail the diagnosis that I see and we see of the problem that we have today and the basic structural dimensions; the reasoning process that we went through, in a logical, step-by-step order, on the four major components of the budget: taxes, defense, the domestic spending that we need and the domestic spending that we cannot afford, that resulted in the type of plan that has been presented to you today.

I have organized this presentation into bullets, because there is no time for florid prose. But we have to understand this trillion-dollar monster. We have to grasp its dimensions. We have to locate where the choices are. And I hope at least the committee will give some consideration to what I think is a logical and explainable process and the reasoning that we went through to reach the recommendations that we have.

To start, I can skip over the baseline very quickly. You are aware of the dimensions of the problem, that even if we assume a healthy economy over the next several years—4-percent real growth, 4-percent inflation, falling interest rates, falling unemployment, whether realistic or not—if we assume those economic performance variables as we have, we nevertheless end up with the size numbers you see at the middle of page 1, a baseline deficit of $230 billion in the budget year ahead; spending, if unchecked and unreformed, that will cross the trillion dollar threshold for the first time in history; spending that seems to be stuck up in the range of 24 to 25 percent of GNP, unless we take decisive and thoroughgoing action, compared to revenues at 19 percent; a deficit burden to finance greater than 5 percent of GNP for the fourth year running.

DUMPING BONDS ON FINANCIAL MARKETS RISKY

It would simply be too risky to think that we could get away with 1 or 2 or 3 more years of dumping that massive magnitude of bonds on the financial markets without repercussions and without adverse reactions in our economic system.

At the bottom of the page, I note that if you put the 1986 budget baseline that we begin with in the context of prior business cycles, we are truly and clearly and dangerously in unchartered waters. By the fourth year of the 1975-76 cycle—that is, fiscal year 1979—the deficit was 1½ or 1.7 percent, of GNP. It required 26 percent of our net national savings to finance it. The cycle of the early seventies, the deficit in the fourth year of the cycle, 1974, was only a half percent of GNP, and it took only 6 percent of our net national savings to finance it. The rest was available for investment and jobs and economic growth.

But here we are, looking at the baseline for 1986. If nothing is done, and the optimistic economic assumptions that we have used prevail, the deficit will still be 5½ percent of GNP. It will absorb more than two-thirds of the net national savings available to finance it, and that means that we have to continue borrowing abroad; that means that the dollar exchange rate would have to stay high; that means that the brutal punishment now occuring in the tradeable goods sector of our economy, as imports flood in and export market markets dry up, would continue at great and devastating cost all across the fabric of our national economy.

So that is not tolerable. The time to act has come, and I think we all know it.

PERMANENT REFORMS IN STRUCTURE OF SPENDING PROPOSED

At page 2,[1] I outline as briefly as I can the overall dimensions of the freeze-plus plan that the President has proposed in this budget. And whether or not for the moment you agree with the entire composition of where these changes to the baseline take place, I hope you will agree that we have charted a course that is the minimum necessary in terms of remedying this fiscal imbalance, closing this intolerable structural deficit for the years ahead. Because we have proposed permanent reforms in the structure of spending, not simply a one-time hit and back to business as usual. That $51 billion in savings the first year doubles by 1988, the third year, and triples nearly by the fifth year, slicing a wedge out of the budget that will begin to reduce the imbalance.

Chairman DOMENICI. Would you hold just a moment?

Senator Exon, can you sit there comfortably with those cameras behind you, or would you like them moved?

Senator EXON. Wherever you want them, Mr. Chairman.

Chairman DOMENICI. Well, they are not helping you; they are right at the back of your head, so I will accommodate. Is there any way that the cameras can accommodate the Senator there?

Senator EXON. Well, I do not think the Senators are important. [Laughter.]

Chairman DOMENICI. Why don't you all move it back this way, so those last two can get a little more space, would you? I do not know why they chose to be on that side.

All right. Let's go.

Mr. STOCKMAN. Mr. Chairman, to continue, let me just suggest that there is one number on this page that I hope will become a benchmark for this committee, and that simply is that over the 5 years of the remainder of this decade, we are proposing to take one-half of a trillion dollars out of the built-in baseline of spending and deficits, and if we can do that, we will start to put the dimensions of this budget back into a more acceptable path. If we do it on the spending side as we propose—and I will lay out the reasons in a moment—the spending share of GNP will drop from 25 percent this year to 23 percent in 1986, the budget we are working on, to under 21 percent by the end of the decade. The deficit will decline from well over $200 billion this year to $180 billion in the budget year we are working on, to under $100 billion by the end of the decade.

But most importantly, we will move the deficit from the danger zone that it is in today, absorbing 5 percent of GNP, to less than 2 percent by the end of the decade. Those are the goals, those are the targets that we must have.

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[1] See p. 28.

SEVEN DIFFERENT TYPES OF MEASURES TO MAKE CHANGES PROPOSED

We have proposed seven different types of measures to make changes on the spending side that cumulate to produce these enormous changes in the path that the budget is now on: selective cost-of-living freezes; across-the-board freezes of discretionary budget authority; major mandatory entitlement program reforms, including student aid, veterans, farm price support, Federal retirement, and many other programs that we have not touched or dealt with in the past 4 years; 25 major program terminations ranging from general revenue-sharing to SBA, Amtrak, the Export-Import Bank direct loans, UDAG, and many others--not because they are necessarily undesirable or bad programs, but simply because under the circumstances and given the choice available, we cannot finance them—10 percent cuts in the administrative overhead of every agency in the executive branch; reductions below the freeze in certain programs that we want to retain but do not merit the priority that would allow us to fund them at higher levels; and modest restraint in the defense buildup plan that we have launched for this decade.

Now, what I would like to do in the remainder of my testimony is to go through carefully how we got to this half-trillion-dollar deficit reduction plan over 5 years, as we assess the basic structure of the fiscal circumstance that we are in.

Point one, we begin with spending reduction as the first resort in order to solve the problem. The President unequivocally pledged to the American people that he would not raise taxes to solve the deficit and received an overwhelming mandate for that position.

I would suggest to this committee today, recalling as I do the intense debates that we have had about taxes versus spending over the last 3 years, that the democratic electoral process has decisively resolved that issue and that philosophical debate.

The immediate, overwhelming, and exclusive priority must now be on fashioning a far-reaching spending reform and reduction program sufficient to steadily shrink the Federal deficit and meet the goals that we have laid out.

Moreover, I would suggest this morning that this premise that spending reductions are the first resort is validated by a larger view of our present fiscal situation. Twice in this decade, the American people have rejected rising tax burdens. In 1980, they voted against bracket creep, and in 1984, against the Mondale plan. These strong electoral preferences point to the pre-1980 levels of Federal spending and taxes, as appropriate targets for fiscal policy.

STRUCTURAL DEFICITS ROOTED IN SPENDING SIDE

And as I show in the middle of this page, compared to the pre-1980, or the 1962 to 1980 tax and spending benchmarks, it is clear that the structural deficits that we confront in the 3 years ahead is rooted in the spending side of the equation. Over the two decades prior to 1980, we took about 18.9 percent of GNP in taxes at the Federal level, on average—some years, up a little bit, some years, down, but always corrected by Congress as the American people sensed the tax burden was becoming too high.

For 1986 to 1988, under current law, with the tax increases we have had in the last couple years, we are now taking once again 19.1 percent of GNP, exactly the historical average that we had lived with and funded our Government on for two decades in the modern period, where the defense requirements and the domestic requirements have largely remained unchanged.

On the other hand, if you look at the second line on the spending share of GNP, over that 20 years of cold war and hot war, over that period of wars on poverty and stepping back because some of the programs did not work, we nevertheless averaged spending 21 percent of GNP at the Federal level over two decades.

We now have built in more than 24 percent, almost 4 percent more. In terms of starting benchmarks, it is clear that the excess in most of the structural imbalance in the budget lies on the spending side of the equation.

ORIGINAL 1981 TAX CUTS WENT TOO FAR

I suggest to the committee this morning that these historical benchmarks also help clarify the tax debate that we have had in the last 4 years. I would suggest this morning that given the rising 1980's claim or spending claim on GNP, that the original 1981 tax cuts as they finally came through the legislative sausage mill went too far. Under current GNP and income assumptions, the 1981 act would have generated revenues barely equal to 17 percent of GNP; in fact, as you can see from the chart in the first bank, 16.8 percent in 1987—well below the average that we took in the sixties and seventies, and clearly inadequate when spending was well into the mid-20 percent range.

Senator **Sasser**. Where is this chart, Mr. Director?

Mr. **Stockman**. It is on page 3, Senator Sasser, at the bottom of page 3.[1]

But let me note that that lays out where we were after the Tax Act was enacted in the summer of 1981. Since then, we have had five major tax increase or revenue-raising bills—TEFRA, Social Security, the Railroad Retirement Reform Program, and the Deficit Reduction Act of last year, as well as the dividend and interest bill in the spring of 1983

Those bills have restored the revenue base. This year alone, they will increase by $80 billion the current law revenue take compared to where it would have been at 715 at the end of the 1981 Tax Act. That is nearly 2 percent of GNP that has been recovered or restored.

TAX BASE INCREASED BY $300 BILLION

For the 3-year period as a whole, these five necessary and justifiable revenue-raising measures increased or restored the tax base by $300 billion. So if you look at the bottom bank at page 3 here, you see the current service revenue level at $794 billion; that is 19 percent of GNP. That brings us back to what has been the fair claim on the taxpayers of this economy for more than two decades. And more importantly, as I would suggest, it has fully restored the revenue base to the level where the American people have drawn the line. Policy action to close the deficit must therefore now shift back to the spending side of the equation as the priority of first resort.

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[1] See p. 29.

So I hope those who think that taxes are a necessary part of this equation will consider this kind of analysis, this kind of reasoning, and understand that we have a clear obligation to start on the 24 percent side and work down, and we do not have much political justification or instruction from the American people to start right now on the 19 percent side and work up.

There has been a good case, and I have worked with those who felt it necessary to raise revenues in 1982 and 1983 and 1984, to restore the revenue base. But we have now done that, and it is time to turn back to the spending side of the equation.

Element No. 2, if we start with spending as the first resort, the basic question we have to ask is where is the excess as between the defense side and the domestic side, as we go into the analysis.

I would suggest that our budget leads the way in terms of bringing the total spending line down to a tolerable share of GNP or claim on the economy over time. But obviously, the composition of the spending envelope that we have recognized is already being sharply contested by many members of this committee, from both sides of the aisle, who insist that it contains too much defense spending and too little domestic spending.

I would be the first to grant that history proves nothing per se about the too much/too little debate. Spending priorities for 1986 to 1990 must be based on a hard assessment of our current requirements for national security and the present needs of domestic welfare. But historical benchmarks demonstrate which side of the spending ledger is claiming more than before as we confront this problem in 1986, and where the heaviest burden of proof lies.

Shown in the table on the next page, and that table is on page 5,[1] 6.8 percent of GNP for defense—and that is the baseline level for 1986—is well below the 8 to 9 percent GNP share or defense claim of the pre-1980 period, except for one aberrant and isolated period from 1974 to 1980, where it plummeted well below that level.

DEFENSE SPENDING AT 7 PERCENT OF GNP NOT OUT OF LINE

But I would remind the committee—and this committee was one of the leaders in this regard—that by 1980, an overwhelming bipartisan consensus had concluded that these levels, 5 percent of GNP, were dangerously inadequate and supported 5 straight years of substantial real growth in defense budget resources. Given the continued buildup of Soviet military power, at least in the abstract and in the form of this kind of analysis, there is little basis to claim that defense spending at 7 percent of GNP, which is basically what we are proposing for the next several years, is significantly out-of-line as a starting proposition.

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[1] See p. 31.

By contrast, if you look at that same table, the post-1970 figures for domestic spending of all types and net interest illuminate the essence of our present fiscal dilemma. When defense spending collapsed during the 1970's from nearly 9 percent of GNP at the beginning of the decade to barely 5 percent of GNP by the end, the entire Federal spending envelope was backfilled with an enormous explosion of new domestic spending commitments, programs and entitlements.

By 1980, nondefense spending claimed nearly 16 percent of GNP, compared to 10 percent at the beginning of the decade, a 60-percent larger share than in 1966–70, while total spending increased by only 3 percentage points.

The 1970's were thus, I would suggest, a political and fiscal paradise. In real terms, domestic spending by 1980 was nearly $300 billion higher in 1986 dollars than it was in 1970. We were doing more things for more people than we had ever dreamed of before, and we did it without a significant tax increase and without serious fiscal imbalance.

In the 1980's, though, I would suggest to this committee that the fiscal paradise of the seventies became the purgatory in which we now struggle. As the military buildup pushed the defense claim up partway toward its pre-1970 levels, up from 5 percent to 6 and now toward 7, the domestic claim receded only slowly despite substantial reductions and spending reforms in 1981–82. As a result, unprecedented deficits were realized during this period, and the debt service burden on GNP rose to 3.5 percent, compared to less than half of that in the pre-1975 period.

So that is how we got to 24 to 25 percent of GNP, and if we are to reduce that imbalance and maintain the historic tax claim, we have got some enormous decisions to make.

I would suggest that the analysis in the middle of page 5, as you track this through; and how we got away so easily in the seventies, and how we have such excruciating problems to resolve in the 1980's; suggests just this point to begin with. The burden of proof on where to make the large reduction is clear: Defense at around 7 percent of GNP is not too high unless it can be convincingly shown that current budget levels proposed by the administration exceed true requirements of our national security. And by the same measure, domestic spending at 14 percent of GNP is still too high unless it can be shown that the current claim is essential to national well-being and constitutes the minimum essential size of Government.

We began with those considerations, those realities. And for the remainder here, I would like to walk through why we concluded that as we analyze the situation of the mid-1980's, that this distribution of that spending envelope that we are trying to shrink is basically correct.

DEFENSE FREEZE ADVOCATES HAVE SOME HARD QUESTIONS TO ANSWER

Let me start with the first element that seems to be preoccupying this committee and the debate, and that is the question of defense. Let me begin by asserting that defense is not out-of-line, and there are some very hard questions that defense freeze advocates have to answer.

This is not to suggest that reasonable men cannot disagree on the precise dollars, and I have, and you all know it, with what we have in this budget. But we have to look at it in the larger context, and I think there are some things that those who want to freeze the budget have to now answer and some pretty firm and some pretty definite details.

The administration's budget request of $314 billion for 1986 does not embody a totally new, novel, and radical plan that was secretly cooked up in the Pentagon since Congress last visited the issue 4 months ago in the fiscal year 1985 appropriations bill. In fact, it is precisely the opposite. It mostly represents old business—the 1986 funding installment of a wide range of policy requirements ranging from force structure to pay levels, operations and readiness, weapons modernization programs and global military missions and capabilities—which have been debated and endorsed by the Congress over the last 5 years, and the request for 1986 is simply the bill, the cost, of implementing most of those decisions. There is nothing new in it in its broad outline.

Those who loudly advocate a defense budget authority freeze, I would suggest to the committee, are playing Rip Van Winkle. After 5 years of voting for nearly all of the program elements which drive the 1986 budget cost, they now shout, "The number is too big."

Senator BOSCHWITZ. "Big enough"—not "too big".

Mr. STOCKMAN. Well, the number is not "too big" or "big enough". The point is that we want to analyze how we got there.

FREEZE ADVOCATES ARGUE WITH OWN RECORDS

But they have not explained which previously accepted weapons systems they want to cancel, which approved missions they would forego, which elements of the force structure they would deactivate, or which readiness and pay accounts they would underfund. Yet a budget authority freeze in the objective and empirical sense requires some or all of these explicit reversals of prior congressional policy. In effect, freeze advocates are arguing with their own records, as a brief review of defense spending trends since 1980 clearly demonstrates.

There is nothing wrong with that. We might want to reconsider decisions that have been made. But let us understand that that is precisely what we are doing.

The reason that I suggest this is shown on the top of page 6.[1] Over the last 5 years since we began the buildup of fiscal 1981, Congress has appropriated $1.2 trillion for defense in enacted appropriations bills, and that totals 95 percent of the administration request.

If you look at those numbers year by year, and the slim differences relative to the size of the request in each case, I would suggest to the committee that this does not suggest a massive policy argument over purposes, objectives, and the kinds of capabilities and forces that we need. Instead, it shows minor quibbles and arguments on the margin over the precise numbers for each year and the precise increment of growth. That is the only thing that you can conclude from a path that has been 5 years in the making. If this were only 1 year, you could say it was an aberration, that we did not know what we were doing. But this is 5 years. This is the result of dozens of congressional committees and dozens and dozens of members who are knowledgeable and expert in these areas, spending literally thousands of hours going through the request, making decisions, choosing some things and not others. And it is hard to say that somehow, this number of $314 billion suddenly appeared out of the blue and has surprised everybody, because it is just not true.

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[1] See p. 32.

LONGRUN COSTS NOT SIGNIFICANTLY TRIMMED

Even if we take the 5-percent dollar difference that we have had for 5 years running, even that is less significant than it may seem. Most of the proportionately small congressional amounts that have been cut involve bookkeeping, pricing, and pacing issues, trims which do not significantly lower the longrun cost of the approved program and the major cost-driving elements within it that the Congress has gone along.

I provide for purposes of illustration here a breakout of the $21 billion that was cut from the 1985 original request and got us from 305 to 285, into categories that are laid out before you.

As you can see in the first bank there, nearly $8.7 or $9 billion was simply arguing about fuel costs, inflation recaptures, and what financing authority other than new budget authority we would use in order to fund the program that was being requested.

We had an argument about Peacekeeper, for instance, and Congress gave us 21 missiles. But then we funded those 21 missiles with 1.5 billion dollars' worth of recaptured budget authority from prior years, rather than new budget authority, and you scored that as a cut. But it was not. That part of the program was approved.

We reestimated on the Hill the fuel, stock fund and foreign currency prices to be expected during the next year, saved $2.7 billion from the request. But that was not a cut; it was a repricing that allowed the basic program to move forward and on and on.

On the next page, I would suggest that another $5.5 billion of that $21 billion cut did not involve serious and basic policy arguments about objectives or systems, but simply minor or modest quibbles about the precise quantity or pacing of certain procurements, certain activities for the year. And as you read down these stub items, I think you will see that that is precisely the case.

Finally, on the bottom, about 30 percent of the cut that was made can be said to argue to involve significant program differences, but even there, you will see nothing big, nothing major, nothing with long-term cost implications that was seriously cut. SDI was approved, but at a slightly lower rate of increase than was proposed. The Sergeant York gun, which was in big trouble on its test, was deferred, but not eliminated. And the Peacekeeper request was cut in half. But in the main, there is very little that you can find here that will affect the longrun cost of the program.

MANY EXCESSES SQUEEZED OUT OF 1986 REQUEST

I would like to suggest, regarding the 1986 request, that many of the purely pricing excesses that were cut in 1985 and prior years have already been squeezed out of the 1986 request—such areas as fuel costs, foreign currency valuation, O&M revolving funds, weapons system inflation and cost escalations, and pay raises.

The 1986 request, therefore, represents in large part the current budget year cost of programs previously approved by Congress in four major areas: new or substantially expanded strategic and conventional weapon systems; operations, readiness, and sustainability; force structure and military pay, and conventional RDT&E.

In the next couple pages, I have tried to lay out the track record of what we have decided, what we have approved over the last 5 years in each of these cases, and why the 1986 price tag comes out the way it does and how it is not incrementally different from the path that was underway and the amount that was approved for 1985.

Let us start with the new weapons systems. Since 1980, Congress has approved 33 new or substantially expanded strategic or conventional weapons investment programs. The 1986 request is $46 billion, compared to an enacted funding level in 1980 of $4 billion. So we are up $40 billion over 6 years.

But most of this growth has already occurred, in 1981 through 1985, in the appropriations approved and the systems accepted and supported by the Congress. In fact, the small growth of $4 billion from last year's level in 1986 represents a planned and expected rise in the funding schedule for approved systems like the C5-B, the D-5 missile or Trident II, the INF forces, and the LHD-1 amphibious assault ship.

Those who are surprised at the size of the 1986 defense numbers have not been attentive, I would suggest this morning, to the longer term implications of the 1981-85 congressional weapons system decisions embodied in the table on page 9.[1] A freeze of the defense budget would require canceling numerous of these systems that have contributed to the sevenfold expansion of funding over the last 5 years.

If you will look with me just for a second at this table, I think it is a pretty dramatic and clear indication of how we got where we are today.

If we start with the top bank of strategic weapons, all seven of these systems were "new" in the 1980's; they were barely underway or have started procurement and major funding since 1980. For those systems, we spent $1.3 billion in 1980, and as you track across that subtotal line, you can see that by 1985, in the bill that you approved, we were up to $19.2 billion as these programs moved forward—the B-1 bomber, Peacekeeper, the Midgetman that was added in the middle of our argument over these things, the Trident II missile program, which nearly everyone supports, to my knowledge, the INF, Cruise missile, and Pershing Programs, that have been broadly supported.

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[1] See p. 35.

If you look in the last column, the 1986 request is $20.8 billion—only a very modest change from the $19.2 billion that was approved in 1985, and that is largely driven by the Trident II program that is moving toward research, maturity, and the increase for SDI that we and many in the Congress would like to have.

There is nothing out of line here, there is nothing startling here. This is simply the 1986 cost of what we have concluded we need in order to maintain a triad strategic deterrent and in order to remedy the deficiencies that we saw in our position in 1980, when we were spending practically nothing on these systems.

I could make the same argument regarding the bottom bank. Items 8 through 33 are 25 conventional systems, aircraft, tanks, ships, of a number of varieties, that we have put into production or substantially expanded the pace, procurement and funding since 1980. Again, if you look at the subtotal line for that whole array of weapons, from the AV-8B that we started in 1981, up at the top, to the Maverick and Stinger missiles, down at the bottom, we were spending $4.7 billion in 1980. But as we began the buildup, those numbers rose rapidly, until 1985, the funding level was $22.5 billion, and the request for 1986 is only modestly higher as these systems move forward in production.

BUDGET GREW BECAUSE OF NEED TO REMEDY DEFICIENCIES

Overall, for both the major conventional and strategic systems that we have decided since 1980 that we need, we have moved from a funding position of $6 billion at the beginning, to $42 billion nearly by 1985, and our request is only slightly higher for 1986, $45 billion, as we move forward toward the middle and latter stages of completing these systems.

If you want to understand why the budget grew from $6 billion to nearly $45 billion over that period, it was because we decided that these things were necessary and that very rapid and huge real growth was needed in the early period to remedy our deficiencies And you see that in the real growth rates at the bottom.

But the point is, these things are now in the base of the budget. These things are now instream. They are going to add to our security in the remaining years of this decade, and the growth rate is coming way down, but the base is high, and we are going to have to continue to fund it, unless someone wants to rethink these issues.

If you turn to page 10,[1] I take up the second component of what is driving the defense budget and the numbers that we are dealing with in 1986. That concerns readiness, sustainability and the operations of the force. I would suggest that what we are proposing for 1986—and you can see it in this table—is fully consistent and along the path of what we have decided to do over the last 5 years.

Total funding in the enacted 1985 appropriations bills for operations, plus the spares and the ammunitions which are necessary for readiness and sustainability, grew from $50 billion to $90 billion, because we made decisions that investment and spending in these areas had to go up.

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[1] See p. 36.

$5 BILLION REQUEST IS CONSISTENT

The additional $5 billion that we are requesting in 1986 is consistent. In the case of O&M, for instance, we are asking for 3.7 percent real growth, which is well below the 6.4 percent average of the last 5 years. In the case of replenishment spares, it was actually negative real growth; we have held that down in 1986, compared to the much higher averages in previous years, meaning that we are beginning to solve the problem.

If you look at the whole table, you will see that, for what you might call the operations and readiness/sustainability end of our defense capability, we felt it necessary to support 13 percent real growth on average each year from 1981 through 1985. If we are going to avoid turning back and retreating on that, we will need some slight real growth in 1986, but overall it is only 3.5 percent.

The issue is not the $95 billion that we need in 1986. The point is the $90 billion that we appropriated last year, after 5 years of efforts to restore this part of our defense capability.

Turning to the third component on page 11,[1] the 1986 request for military personnel essentially reflects the end strength and force structure enhancements that have been supported and approved by the committees and the Congress since 1980, along with the early pay catch-ups that we had in 1981 and 1982.

Over the 5-year period through the enacted appropriations bill for 1985, end strength in the services was increased by 102,000, or 5 percent—to permit activation of new units and fill out existing forces.

Cumulative pay increases of 44 percent were made to restore competitiveness, recruitment, retention and morale.

The resulting $28 billion in military personnel cost increases from 1980 through 1985 is now locked into the base. Since the planned 1986 pay raise is very modest, only 3 percent, significant savings could be achieved in this area only by reversing the 1981-85 policy decisions and deactivate selected units.

1986 INCREASE EMBODIES PREVIOUSLY APPROVED PROJECTS

Finally, on the fourth component, conventional RDT&E—and I might just note that the strategic RDT&E was included with the strategic investments in the first component—but we have nearly doubled that between 1980 and 1985, reflecting a consensus policy objective of maintaining the superiority of the U.S. military technology base. While the 1986 increase is larger than prior years, it embodies significant funding growth for previously approved projects that are now moving into a mature phase of the development cycle and will require more money each year.

Examples include the C-17, the transport aircraft, the JSTAR's program, the JVX rotor aircraft, the advanced tactical fighter, and many more. A budget authority freeze would severely disrupt dozens of programs essential to future security requirements. And again, the numbers path and the decision train that we have approved is shown at the top of page 12.

Now, the above four categories account for more than 75 percent, or $133 billion of the total DOD budget authority growth of $175 billion, between the 1980 base when we started to remedy this defense deficiency that we had, and the 1986 request that is now before you. Dozens of major programs and policy decisions have been ratified by Congress over the intervening 5 years, and these elements drive the 1986 funding level.

While the linkage of any single item to objective national security requirements is always a fair topic for debate, the cumulative weight of executive and legislative branch scrutiny, analysis and debate places a strong burden on those who would radically disrupt the funding build-up path.

FREEZE ADVOCATES MUST DO MORE THAN CUT NUMBERS

To achieve a 1986 budget authority freeze would require cutting the administration's request in just these four areas or accounts by nearly $19 billion. This cannot be done exclusively through reform and economizing—steps which would yield savings only in the very long run and of far smaller magnitude than commonly supposed.

Freeze advocates must therefore propose to do more than cut the number. They must demonstrate which previously approved systems, programs, capabilities and forces they would delete in order to reduce the funding requirement for 1986 and future years.

I would close this point of the argument by noting that Congress will undoubtedly trim small amounts from the 1986 request, as in past years, reflecting repricings, financing adjustments, modest program deferrals, and the like. But as previously shown, the main cost-driving elements have been strongly ratified and will remain in place. These policies will lift the defense claim on GNP slightly above 7 percent over the next several years, a figure which is not too high given the consensus view of current requirements embodied in the 1980–85 buildup and the decisions that Congress approved.

So now we go to the fourth component, and that is the conclusion, by this process of reasoning, that domestic spending is still too high, and we have to ask the question where can the reductions be taken.

I would note for the committee that the 1986 baseline for nondefense spending would total nearly $593 billion, or 14.1 percent of GNP if fully funded. For purposes of presentation today and thinking about this, I think you can divide the baseline into three basic categories: $289 billion for social contract expenditures in Social Security, Medicare, unemployment insurance and related smaller programs, mainly railroad retirement and black lung; second, $92 billion for the means-tested safety net and related social services support activities targeted on the low-income populations where the fairness debate has been waged with great fury over the last several years; finally, $211 billion for all of the other public sector functions of the Federal Government, old and new, valid and questionable.

The job that we have in this budget is to determine what can and should be changed in these three areas. The answer that we propose from the administration goes as follows.

REDUCTIONS WOULD VIOLATE EXPLICIT COMMITMENTS

First, significant reductions in social contract expenditures would violate explicit commitments, both from the distant and more recent past, to more than 40 million elderly, disabled, or unemployed Americans. It would undermine their basic financial and social well-being. The savings proposed in the President's budget, therefore, are modest compared to the baseline cost and are achieved primarily through Medicare provider freezes, and some small changes in beneficiary eligibility and cost-sharing requirements. They contribute just 8 percent of the $50 billion total over 1 year and the half trillion total over 5 years, and the numbers are laid out for you in this chart.

In combination with the prior reforms that we have implemented in this area, three times on Medicare, a big fix on Social Security in 1983, the railroad retirement reforms, the unemployment reforms of 1981, I think you can say that the social contract burden on the budget and the economy has been put into a stable condition, and if we maintain these levels with the changes we are proposing, will decline, as you can see at the bottom of page 13, as a share of GNP steadily over the remainder of the decade if we keep the economy growing. We are not taking anything away from anybody, but it is simply that we have now a stable policy level that the economy can grow away from, if we can get our fiscal house in order and keep our economy prosperous.

Chairman **Domenici**. Mr. Stockman, if you could wait just a moment, please. We have to in some way ask you to expedite the remainder of your testimony.

The Senators are prepared to stay here for the morning and into early afternoon, but we have to have some opportunity to engage in some serious questioning. Could you summarize the rest of your statement in 5 or 6 minutes, Mr. Stockman?

Mr. **Stockman**. Mr. Chairman, I can do that, and I think I am nearly through the points that I wanted to make.

REDUCTIONS DO NOT FALL ON SAFETY NET

Let me then turn to the second component of domestic spending, the means-tested safety net programs and related social service programs, which are listed for you on page 15, and simply make these points.

Ninety percent of baseline spending has been maintained in this area because we believe the problems were fundamentally fixed in 1981, and 90 percent of the total budget savings that we are recommending occur outside of this component of the budget.

Some of the programs are not changed at all, like SSI or food stamps. The appropriated service programs are frozen for the most part, and no more. And the targeted reforms and savings that we have recommended occur in areas where I believe that savings can be made without any undue hardships or impact on the beneficiaries.

We are proposing, for instance, to cap Medicare reimbursement to the States, but to maintain the existing entitlement protections to the beneficiaries, and require the States to do a better job of cost control, like we are doing with Medicare at the Federal level.

We are proposing to keep the School Lunch Program intact for the poor and the reduced price students, but to eliminate the subsidy of 22 cents for those in the upper brackets.

Overall, if you look at this table, you will see that the burden of spending reduction that we are proposing does not fall on the safety net by any stretch of the imagination, and those who insist that it does are simply trying to revive an old debate that is no longer needed and confuses us as to what should be done.

SOME FUNDAMENTAL CHOICES MUST BE MADE

Finally, therefore, we come to the final component of the budget—other nondefense spending—and we have to get to the ultimate question, which is what public sector functions can we afford, and which do we need.

I point out in this table that there is $211 billion built in as a result of an accumulation of commitments over decades, based on ad hoc rules regarding appropriate Federal activities and political responses to every manner of special interest pressure.

We have now arrived at the day of reckoning: We cannot afford it all and must make fundamental choices between where we spend and where we save.

I would note that 80 percent of our savings come in this area, and they come under three headings. Purely local economic development subsidies and fiscal aid are no longer affordable and produce few net national benefits, so we believe these programs should be eliminated: revenue sharing, UDAG, EDA, the other local development subsidies, mass transit capital and operating assistance. If these public sector purposes are to be served, they must be financed with local taxes where people can better match what they are getting with what they are paying.

Second, we have proposed that major benefit programs have expanded well beyond their original purpose or promise, and they should now be pared back. The veterans health care system is one example. We must move to a means test. Student grants in aid are another example, $8 billion per year—half of all the freshman students in this country getting support, much of it going to middle and upper income families. We must impose a means test that redirects benefits and help to those on the lower end of the scale, because that is all we can afford.

Civil service retirement benefits are too rich, and they must be scaled back through a series of measures that we are recommending to you in this budget.

DRAW THE LINE ON SPECIAL INTEREST PRESSURE

Finally, we get to the heart of where the controversy is, the special interest pressure, and indeed, even the political pork barreling in the budget, and that is the whole welter of subsidies that have built up over the years in various businesses or sectors of the economy or regions of the country.

The time has come to draw the line. The time has come to eliminate or radically reduce these expenditures, which are nice to have if we can afford them, but cannot be justified under current circumstances, and in many cases are counterproductive.

So we have recommended major changes in the farm price support program, putting it back on a market basis, and targeting aid only to the low end of farmers with a cap of $20,000 per year.

We have proposed to get rid of Amtrak, SBA, Export-Import Bank lending, and a variety of smaller business subsidies.

We have proposed that navigation interests pay user fees to cover their costs.

We do not need REA anymore; it is time to get rid of it.

It is time that the power users in the Northwest and elsewhere pay back their debt to the Federal Treasury and help us reduce our problem.

If you look at the final page of my testimony, you can see it very clearly, very starkly, how we end up getting nearly three-fifths of our spending reduction in this 20-percent sector of the budget, where the time has come to bite the bullet and make the choices; $30 billion of the $50 billion the first year, or $39 billion in nondefense, noninterest savings, comes from this sector, and the same is true throughout the year.

RESTORING FISCAL BALANCE BY END OF DECADE

I would finally call your attention to the plan that we see for restoring fiscal balance by the end of this decade, which is put in shorthand here as shares of GNP, in terms of the three major components of the budget.

Social contract: We have reformed it; and we can stabilize it at about 6.5 percent of GNP, with the Medicare reforms we are proposing.

Social safety net: We are not touching it; we fixed it in 1981. It is constant now at about $90 billion a year. If we can maintain those efforts, and if the economy keeps growing, its share of GNP will decline from a little over 2 percent when we started in 1980 to 1.7 percent by 1990.

So you can see where the big change has to occur. When we started in 1980, we were spending nearly 7.5 percent of GNP, not for the elderly, where we have made commitments, not for the low-income, where we have needs, but in the whole accumulation of baggage that we have stuffed into this budget over 30 years, to help farmers and to help barge operators and to help people in one section and another section of the country, to reduce the cost of the farebox in mass transit, to increase the number of jobs that might occur in Appalachia and elsewhere. That is the part of the budget that has to be radically shrunk if we want to live under the historic tax burden that we have had on the American people at 19 percent.

So far, we have taken that down to 5.7 percent in 1985, as you can see; it drops to 4.3 percent when the first year installment of our changes are implemented in 1986, and down to less than 3 percent of GNP by 1990, if all of these changes that I have discussed here very briefly are implemented.

That may not be the plan that appeals to all members of this committee, but I would suggest there are few other choices as you step through and walk through the difficult problem that we have got to grapple with in the months ahead.

I apologize to the committee for the length of time it took to go through this. But I think before we get into all of the usual wrangles and all of the political rhetoric, about what we can and cannot do, about what is possible and what is not, we at least ought to make an effort to get a basic picture of this problem and to understand the reasoning that various parties in the debate have used to come to their conclusions. This is the reasoning from the administration.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you, Mr. Stockman.

[The prepared statement of Mr. Stockman follows:]

TESTIMONY OF THE

HONORABLE DAVID A. STOCKMAN

DIRECTOR,

OFFICE OF MANAGEMENT AND BUDGET

BEFORE THE

COMMITTEE ON THE BUDGET

UNITED STATES SENATE

FEBRUARY 5, 1985

THE PRESIDENT'S 1986 FREEZE PLUS BUDGET PLAN

Baseline Assumptions

- The nation is facing unprecedented structural deficits which must be decisively corrected to maintain a healthy financial system and continued non-inflationary economic growth.

- The Budget estimates assume this policy correction will be made and that the economy will move along a path of 4% real growth, 4% inflation and steadily falling unemployment and interest rates over the next several years.

- The magnitude of the required fiscal correction is enormous. Without policy changes, baseline spending will average 24.4% of GNP, and current law revenues 19% of GNP -- leaving a structural deficit in excess of 5%:

	Current Services Baseline		
	1986	1987	1988
Budget Totals (billions)			
o Outlays	$1,024	$1,109	$1,200
o Receipts	794	864	952
o Deficits	$-230	$-246	$-248
Share of GNP (%)			
o Outlays	24.4%	24.4%	24.4%
o Receipts	18.9%	19.0%	19.3%
o Deficits	-5.5%	-5.4%	-5.0%

- While large deficits can be financed without serious dislocations during the early stages of recovery, they generate increasing financial strains and costs as the recovery matures. Fiscal Year 1986 will be the fourth year since the bottom of the business cycle. The following comparison with the fourth year in the prior two cycles indicates that the dimensions of the baseline deficit are unprecedented and the potential absorbtion of net private savings would be 3 to 10 times greater than in prior cycles.

	FY 1974	FY 1979	FY 1986 Baseline
o Deficit share of GNP	.4%	1.7%	5.5%
o Deficit share of net private savings	6%	26%	67%

President's Freeze Plus Budget Plan

- The 1986 Budget reduces spending by $51 billion in 1986, $239 billion over 3 years and $507 billion over 5 years. If the recommended freezes, reforms, cuts and terminations are adopted, the Federal spending claim on GNP, the deficit level, and the deficit burden on the financial system will all decline dramatically over the next several years:

Impact of 1986 Budget

	1985	1986	1987	1988	1989	1990
o Spending cut from Baseline (billions)	$1	$51	$83	$105	$125	$143
o Spending share of GNP	24.8%	23.2%	22.6%	22.2%	21.4%	20.9%
o Deficit level (billions)	$-222	$-180	$-165	$-144	$-107	$-82
o Deficit share of GNP	5.7%	4.3%	3.6%	2.9%	2.0%	1.4%

- The massive spending reductions required to restore fiscal balance require a fundamental reappraisal of the entire range of Federal spending commitments. The Administration's review resulted in 7 major initiatives to shrink baseline spending commitments and steadily reduce the Federal outlay claim on GNP to minimum essential levels of Government. These initiatives include:

  - Selective cost-of-living freezes excluding Social Security and means-tested benefits.
  - Across-the-board discretionary budget authority freezes in nearly all non-defense programs.
  - Major mandatory spending program reforms including student aid, veterans health care, farm price supports and Federal retirement.
  - 25 major program terminations including GRS, Amtrak, Small Business Administration, Export-Import Bank direct loans, UDAG and many others.
  - 10% cuts in all administrative expense accounts.
  - Cuts below the freeze level in desirable but lower priority programs like energy research and CDBG block grants.
  - Modest restraint of about $10 billion per year in the nation's defense build-up while maintaining all programs essential to national security.

Spending Reduction as the First Resort

- The President unequivocally pledged to the American people that he would not raise taxes to solve the deficit and received an overwhelming mandate for that position. The democratic electoral process has thus decisively resolved Washington's 3-year long philosophical debate about tax increases vs. spending reductions. The immediate, overwhelming and exclusive priority must now be on fashioning a far-reaching spending reform and reduction program sufficient to steadily shrink the Federal deficit. Moreover, this premise is validated by the larger view of our present fiscal situation.

- Twice in this decade the American people have rejected rising tax burdens: in 1980 they voted against bracket creep and in 1984 against the Mondale plan. These strong electoral preferences point to the pre-1980 levels of Federal spending and taxing as appropriate targets for fiscal policy. Compared to the 1962-1980 tax and spending benchmarks, it is clear that the 1986-88 structural deficit is rooted in the spending side of the equation:

	1962-1980 Actual	1986-1988 Baseline	1986-1988 Excess
o Federal taxes as percent of GNP	18.9%	19.1%	.2%
o Federal spending as percent of GNP (baseline)	20.6%	24.4%	+3.8%

- These 1962-80 benchmarks also help clarify the tax debate of the last four years. Given the rising 1980's spending claim on GNP, the original 1981 tax cut clearly went too far. Under current GNP and income assumptions, the 1981 act would have generated revenues barely equal to 17% of GNP -- well below the 1962-80 benchmark norm and clearly inadequate with spending at 24-25% of GNP levels. The five 1982-84 tax bills were therefore essential to restore the revenue base to at least the status quo ante. The nearly $300 billion increase over 1986-88 resulting from these revenue raising bills increased the tax claim by nearly 2.5% of GNP compared to the ERTA levels.

	1986	1987	1988
1981 ERTA Policy			
o Receipt levels with 1981 ERTA policy (billions)	$715	$765	$836
o Receipt share of GNP	17.0%	16.8%	17.0%
1982-1984 Revenue Bills			
o Increase to ERTA levels (billions)	+$80	+$99	+$116
o Increase as percent of GNP	+1.9%	+2.2%	+2.4%
1986 Current Services Receipts			
o Receipt level (billions)	$794	$864	$952
o Share of GNP	18.9%	19%	19.3%

- o The Federal revenue base has now been fully restored to the level where the American people have drawn the line. Policy action to close the deficit must now shift back to the spending side of the equation as the priority of first resort.

Federal Spending: Where's the Excess?

- o The Administration's Budget leads the way on spending reductions as the first resort: the current 24-25% of GNP level is reduced to 20-21% of GNP range by the end of the decade -- a target fully consistent with the 1962-80 average of 20.6%. However, the composition of that spending envelope is already being sharply contested by those who insist it contains too much defense spending and too little domestic spending.

- o History proves nothing per se about the too much/too little debate. Spending priorities for 1986-90 must be based on a hard assessment of our current requirements for national security and the present needs of domestic welfare. But historical benchmarks demonstrate which side of the spending ledger is claiming more than before and where the heaviest burden of proof lies.

- o As shown below, the 6.8% of GNP defense baseline spending level for 1986 is well below the 8-9% pre-1980 average -- except for the post Vietnam years of 1974-1980. But by 1980, an overwhelming Bipartisan consensus had concluded these levels were dangerously inadequate and supported 5 straight years of substantial real growth in defense resources. Given the continued build-up of Soviet military power, there is little basis to claim that defense spending at 7% of GNP or less is significantly out-of-line.

- o The post-1970 figures for domestic and net interest claims on GNP illuminate the essence of our present fiscal dilemma. When defense spending collapsed during the 1970's from nearly 9% to barely 5% of GNP, the entire spending envelope was backfilled with an explosion of new domestic spending commitments. By 1980, non-defense programs claimed nearly 16% of GNP -- a 60% larger share than in 1966-70, while total spending rose by less than 3 percentage points of GNP. The 1970's were thus a political and fiscal paradise: in real terms, domestic spending by 1980 was nearly $300 billion above its 1970 level without a significant tax increase and without serious fiscal imbalance.

- o In the 1980's, the paradise became purgatory: as the military build-up pushed the defense claim up part-way toward pre-1970 levels, the domestic claim receded only slowly despite substantial budget reductions and spending reforms in 1981-82. As a result, unprecedented deficits were realized during 1982-85 which raised the debt service burden to 3.5% of GNP or more than double its pre-1975 claim. Total spending is now 24% to 25% of GNP and must be sharply reduced if fiscal balance is to be restored and historic tax burden levels maintained.

- The burden of proof on where to make the large reduction is clear: defense at around 7% of GNP is not too high unless it can be convincingly shown that current budget levels exceed true requirements. Domestic spending at 14% of GNP is still too high unless it can be shown that the current claim is essential to national well-being and constitutes the minimum essential size of government:

Spending Claims on GNP

	Pre-Vietnam	Vietnam Era	1970's Defense Collapse		1985	1986
	1962-65	1966-70	1973	1980	Actual	Baseline
o Defense (DOD).........	8.5%	8.9%	6.1%	5.2%	6.6%	6.8%
o Non-defense	9.2%	10.0%	12.2%	15.8%	15.0%	14.1%
o Net interest	1.3%	1.4%	1.4%	2.0%	3.4%	3.5%
o Total spending	19.0%	20.1%	19.6%	22.9%	24.8%	24.4%

Defense Spending is Not Out of Line: Some Hard Questions for Freeze Advocates

- The Administration's $314 billion 1986 defense request does not embody a totally new, novel and radical plan secretly cooked up in the Pentagon since Congress last visited the issue four months ago in the FY 1985 Appropriations Bill. It is precisely the opposite: it mostly represents "old business" -- the 1986 funding installment of a wide range of policy requirements -- force structure, pay levels, operations and readiness, weapons modernization programs and global military missions and capabilities -- which have been debated and endorsed by the Congress over the past 5 years. There is practically nothing "new" in it.

- Those who loudly advocate a defense budget authority freeze are playing Rip Van Winkle: after five years of voting for nearly all of the program elements which drive the 1986 budget cost, they now shout -- "The number is too big." But they have not explained which previously accepted weapons systems they want to cancel; which approved missions they would forego; which elements of the force structure they would deactivate; or which readiness and pay accounts they would underfund. Yet a budget authority freeze would require some or all of these explicit reversals of prior Congressional policy. In effect, freeze advocates are arguing with their own records as a brief review of defense spending trends since 1980 clearly demonstrates.

- Congress has appropriated $1.2 trillion for defense over the past 5 years -- 95% of the Administration request:

	1981	1982	1983	1984	1985	Total
			(Dollars in billions)			
o Request	177.1	221.8	257.5	273.4	305.0	1,234.8
o Enacted	178.4	213.8	239.5	258.2	284.3	1,174.2
o Percent enacted	101%	96%	93%	94%	93%	95%
o Real growth rate	12.7%	12.2%	7.6%	4.4%	5.8%	---

- Most of the proportionately small Congressional amounts cut have involved bookkeeping, pricing and pacing issues -- trims which do not significantly lower the long-run cost of the approved program and the major cost-driving elements within it. The $21 billion cut from the 1985 request for example breaks out as follows:

Pricing and Financing Changes

	Millions
o Small reduction in requested pay raises and end-strength increases	$-1,845
o Fuel, stock funds and foreign currency price re-estimates	$-2,679
o Navy ship procurement price re-estimates	$-716
o Battleship reactiviation funded with prior year inflation savings	$-423
o Contingency allowances reduction	$-168
o Army helicopter price re-estimates	$-121
o F-16 inflation savings and re-estimates	$-514
o Peacekeeper procurement partially funded with prior year BA	$-1,500
o Other inflation savings	$-805
Subtotal	$-8,771

Pacing and Quantity Changes	Millions
o Army missile production slow-downs	$-320
o Production rate and procurement level adjustments for Army ammo support vehicles, communications, and other equipment	$-504
o Navy mods, spares and ammo procurement reductions	$-345
o Minor production rate adjustments in Navy missiles, torpedoes, and support equipment	$-758
o Denial of Navy advanced procurement for F-18 and other aircraft	$-140
o Rephasing of several ship construction programs	$-176
o Air Force spares and repair parts procurement slow-down	$-628
o Production rate changes for Air Force support vehicles and equipment	$-483
o Air Force program deferral and production rate adjustments:	
-- C-5 transport, KC-135 re-engining, other aircraft mods and equipment	$-1,251
-- Maverick, AMRAAM and other missiles	$-740
-- Munitions and other	$-199
Subtotal	$-5,544

Program Changes	
o Limiting of real growth in:	
-- non-strategic military construction	$-1,400
-- family housing	$-300
-- non-strategic R&D	$-2,033
o General reductions in ADP, audio-visual, consultants, travel, medical, stock funds and other	$-800
o Scale-back of Strategic Defense Initiative	$-377
o Cancellation of Navy TAK support ship	$-91
o Delay of Sergeant York gun	$-416
o Denial of full Peacekeeper procurement	$-587
o Other defense-wide changes	$-181
Subtotal	$-6,185
Total	$-20,500

- Many of the purely pricing excesses have already been squeezed out of the 1986 request -- in such areas as fuel costs, foreign currency valuation, O&M revolving funds, weapons system inflation and cost escalations, and pay raises. The 1986 request number, therefore, represents in large part the current year cost of programs previously approved by Congress in four major areas:
  - New or substantially expanded strategic and conventional weapon systems
  - Operations, readiness and sustainability
  - Force structure and military pay
  - Conventional R&D
- New Weapons Systems -- Since 1980, Congress has approved 33 new or substantially expanded strategic or conventional weapons investment programs. The 1986 request for these systems is nearly $46 billion -- $40 billion higher than the $6 billion funding base of 1980. However, the 1986 request exceeds 1985 enacted level by only $4 billion -- with most of this growth representing a planned and expected rise in the funding schedule for approved systems like the C5-B, D-5 missile, INF forces and the LHD-1 amphibious assault ship. Those who are "surprised" at the size of the 1986 defense number have not been attentive to the longer term implications of the 1981-1985 Congressional weapons system decisions embodied in the table below. A freeze of the defense budget would require cancelling numerous systems that have contributed to the 7-fold expansion of funding over the past five years.

1986 Cost of 33 New or Substantially Expanded Strategic and Conventional Weapons Investment Programs Since 1980

System	1980 Base	Enacted					1986 Request
		1981	1982	1983	1984	1985	
Strategic Systems							
1) KC-135 re-engining	$96	$219	$395	$529	$720	$827	$868
2) B-1 Bomber	70	260	2,083	4,787	6,868	8,192	6,185
3) Peacekeeper (MX)	732	1,509	1,910	1,930	4,148	4,314	4,040
4) Midgetman	0	0	0	0	467	641	777
5) Trident II missile (R&D)	26	97	241	370	1,473	2,212	2,748
6) Strategic defense (SDI)	0	0	0	0	51	1,397	3,722
7) INF: GLCM, SLCM and Pershing II	378	745	1,165	1,427	1,569	1,598	2,439
o Subtotal, Strategic Systems	$1,302	$2,830	$5,794	$9,043	$15,296	$19,181	$20,779
8) F-18 fighter aircraft	1,067	1,921	2,147	2,470	2,316	2,500	2,762
9) AV-8B attack aircraft	0	87	600	742	788	787	979
10) AH-64 helicopter	0	51	502	802	1,192	1,247	1,234
11) SH-60B helicopter	0	104	673	620	437	432	371
12) EH-60A helicopter	0	0	0	21	152	119	143
13) C-5B Transport	0	0	0	785	1,301	1,580	2,268
14) KC-10 cargo/tanker aircraft	185	307	213	898	732	565	447
15) Army helicopter improvement program	0	0	0	28	185	204	211
16) C-130 modification	12	34	104	154	179	256	213
17) Attack Submarine (SSN-668)	829	1,027	1,328	1,413	1,921	2,665	2,708
18) AEGIS Cruiser (CG-47)	820	1,912	2,917	2,886	2,946	2,985	2,766
19) AEGIS Destroyer (DDG-51)	0	0	0	0	79	1,050	164
20) LHD-1 Amphibious Assault Ship	0	0	45	55	1,366	39	1,507
21) LSD-41 Dock Landing Ship	41	388	298	414	363	490	414
22) Mine Counter Measures Ship (MCM-1)	0	0	99	99	284	345	334
23) M-1 Tank	651	1,348	1,405	1,831	1,720	1,852	2,109
24) Bradley Fighting Vehicle	236	628	827	810	791	962	1,035
25) Harpoon missle	144	174	227	210	275	330	315
26) Stinger	88	85	249	268	183	279	364
27) HARM missile	0	115	106	86	367	574	736
28) TOW missile	19	37	284	162	216	236	271
29) Maverick	4	0	221	285	336	463	726
30) Hellfire missile	0	26	119	246	234	250	306
31) Patriot missile system	396	442	668	788	876	961	983
32) MLRS rocket system	65	115	178	369	526	541	549
33) Navy Standard missile	175	297	442	590	602	741	848
o Subtotal, Conventional weapons	$4,732	$9,098	$13,652	$17,032	$20,367	$22,453	$24,763
Grand total, Strategic/Conventional	$6,034	$11,928	$19,446	$26,075	$35,663	$41,634	$45,542
Memo: real growth rate	--	80.4%	51.9%	26.5%	30.0%	11.0%	4.1%

- o The 1986 operations and readiness/sustainability - related request is consistent with the funding path Congress has approved for five straight years:
    - o Total funding in the enacted 1985 bill was $40 billion above the 1980 base. The additional $5 billion in the 1986 request is consistent with the approved path.
    - o The 1986 requested real growth of 3.7% for O & M is well below the 6.4% 1981-85 average.
    - o Real growth rates for replenishment of spares and ammunition are also modest compared to 1981-85.
- o A freeze would require reduction in flying hours, steaming days, training time, depot maintenance, spare parts availability and other force operations. Freeze advocates have not analyzed or explained the consequence of cuts in this area:

	1980 Base	Enacted 1981	Enacted 1982	Enacted 1983	Enacted 1984	Enacted 1985	1986 Request
Operations and Maintenance							
o Budget level (billions)	$46.6	$55.2	$62.0	$66.7	71.0	78.2	82.4
o Real growth rate (%)	--	8.0%	8.1%	4.6%	4.8%	6.6%	3.7%
Replenishment Spares							
o Budget authority	$1.5	$3.3	$4.6	$4.7	$5.5	$6.1	$6.2
o Real growth rate	--	96.4%	27.9%	-4.1%	12.3%	3.7%	-2.2%
Ammunition							
o Budget level	$1.7	$2.2	$4.2	$3.7	$4.3	$5.4	$6.1
o Real growth	--	17.6%	73.7%	-13.7%	12.1%	21.0%	6.3%
Total, Operations, Spares, Ammunition							
o Budget level	$49.8	$60.7	$70.8	$75.1	$80.8	$89.7	$94.7
o Real growth	--	11.6%	12.2%	27.0%	5.7%	7.3%	3.5%

- The 1986 request for military personnel essentially reflects the end-strength and force structure enhancement approved since 1980 along with prior year catch-up pay increases:
  - Through 1985 Congress approved end-strength increases of 102,000 or 5% -- to permit activation of new units and fill-out of existing units
  - Cummulative pay raises of 43.6% to restore competitiveness, recruitment, retention and morale
- The resulting $28 billion in military personnel cost increases through 1985 is now locked into the base. Since the planned 1986 pay raise is only 3.0%, significant savings would require reversing 1981-85 policy decisions and de-activiation of selected units.

Military Personnel Costs

	1980	Enacted					1986
Measure	Base	1981	1982	1983	1984	1985	Request
o Budget level (billions)	$41.1	$48.5	$55.7	$61.0	$64.9	68.9	$73.4
o Active duty end-strength (000).	2,050	2,082	2,109	2,123	2,138	2,152	2,178
o Pay raise (%)	---	11.7%	14.3%	4.0%	4.0%	4.0%	3.0%*
o Nominal budget growth (%)	---	18.0%	14.8%	9.5%	6.4%	6.2%	6.5%

* Effective 1 July 1985

  - Congressional appropriations for conventional R&D nearly doubled between 1980 and 1985 -- reflecting a consensus policy objective of maintaining the superiority of the U.S. military technology base. While the 1986 increase is larger than in prior years, it embodies significant funding growth for previously approved projects that are moving into a mature phase of development cycle. Examples include the C-17, JSTARs, JVX and the Advanced Tactical Fighter. A budget authority freeze would severely disrupt dozens of programs essential to future security requirements:

Conventional R&D

	1980 Base	Enacted 1981	 1982	 1983	 1984	 1985	1986 Request
o Budget level (billions)	$11.0	$12.8	$15.1	$16.8	$18.8	$21.6	$26.9
o Real growth	---	6.8%	11.5%	6.9%	8.4%	10.4%	19.9%

- The above four categories account for more than 75% ($133 billion) of the total DOD budget authority growth ($175 billion) between the 1980 base and the 1986 request. Dozens of major program and policy decisions have been ratified by Congress over the intervening 5 years, and these elements drive the 1986 funding level. While the linkage of any single item to objective national security requirements is always a fair topic for debate, the cummulative weight of executive and legislative branch scrutiny, analysis and debate places a strong burden on those who would radically disrupt the funding build-up path.

- To achieve a 1986 budget authority freeze would require cutting the Administration's request in these accounts alone by nearly $19 billion. This cannot be done exclusively through reform and economizing -- steps which yield savings only in the very long-run and of far smaller magnitude than commonly supposed. Freeze advocates must therefore propose to do more than cut the number -- they must demonstrate which previously approved systems, programs, capabilities and forces they would delete in order to reduce the funding requirement for 1986 and future years.

- Congress will undoubtedly trim small amounts from the 1986 request as in past years -- reflecting repricings, financing adjustments, modest program deferrals and the like. But as previously shown, the main cost-driving elements have been strongly ratified and will remain in place. These policies will lift the defense claim on GNP slightly above 7% over the next several years -- a figure which is not "too high" given the consensus view of current requirements embodied in the 1980-85 build-up.

Domestic Spending is Still Too High: Where the Reductions Can Be Taken

- The 1986 baseline for non-defense spending would total nearly $593 billion or 14.1% of GNP if fully funded. Baseline outlays can be divided into three basic categories for purposes of analysis:
    - $289 billion for social contract expenditures in Social Security, Medicare, unemployment insurance and related smaller programs
    - $92 billion for means-tested safety net programs and related social service support activities targeted on low-income populations
    - $211 billion for all of the other public sector functions of the Federal government -- old, new, valid and questionable.
- Significant reductions in social contract expenditures would violate explicit commitments -- both from the distant and more recent past -- to nearly 40 million elderly, disabled or unemployed Americans, and would undermine their basic financial and social well-being. The savings proposed in the President's budget, therefore, are modest compared to the baseline cost and are achieved primarily through Medicare provider freezes and small changes in beneficiary eligibility and cost-sharing requirements. They contribute just 8% of the total budget savings proposed for 1986-88.

Social Contract Expenditures: Social Security/Medicare/Unemployment and Related

Program Basis	1986	1987	1988
o Baseline spending level (billions)	$289.3	$310.4	$333.9
o Medicare freezes/reforms	-4.1	-6.3	-8.2
o RR/Black Lung COLA freezes	-0.1	-0.2	-0.3
o President's 1986 Budget level	$285.1	$303.9	$325.4
o Social contract savings as % of total Budget savings	8%	8%	8%

- In combination with reforms implemented during 1980-85, these measures will result in a steady decline of the social contract claim on GNP without violating existing commitments:

Social Contract Share of GNP

1980	1985	1986	1988	1990
6.5%	7.1%	6.8%	6.6%	6.5%

- The means-tested safety net programs and related social service activities were substantially reformed in 1981-82. Only highly selective, targeted reforms and cuts are proposed in the 1986 Budget.
    - 90% of baseline spending is retained and 90% of total budget savings occur in other components of the budget.
    - No changes are proposed for major safety net programs including food stamps, WIC and SSI.
    - Major social services programs including disadvantaged and handicapped education, social and health services block grants, older Americans and Head Start programs and employment and training grants are subject only to the across-the-board freeze on 1986 budget authority.
    - Targeted reforms are proposed for the following programs: caps on Medicaid reimbursement to the states while maintaining beneficiary entitlement protections; elimination of the 22¢/lunch subsidy for families above $19,000; subsidized housing new unit moratorium and vendor payment reforms while fully supporting the existing 11 million low-income tennants; workfare and minor household reforms in AFDC; and elimination of 4 high-cost or outmoded social programs -- legal services, community services, Job Corps and the weatherization program (phase-out through 1990).

Impact of 1986 Budget on Means-Tested Safety Net Programs and Related Social Service Programs

Program	1986	1987	1988
	(Dollars in billions)		
Means-tested benefits funded at current services: SSI, Food Stamps, WIC, Other Nutrition, EITC and Refuge Aid			
o Current services baseline	$24,532	$25,372	$27,087
o 1986 Budget savings	+8	-10	-28
Social Service Programs Funded at Freeze Level			
o Current services baseline	$19,023	$19,703	$20,289
o One-year BA freeze savings	-328	-791	-1,085
Targeted Reforms or Cuts in Selective Programs*			
o Current services baseline	$48,385	$51,547	$55,134
o Freeze Medicaid reimbursement in 1986 and cap out-years at MEPI	-1,000	-2,091	-3,202
o Mandatory AFDC work fare; no independent minor households; parents benefit reform	-229	-198	-190
o Eliminate upper income school lunch subsidy	-648	-906	-1,007
o 2-year HUD incremental unit moratorium and vendor payment reforms	-1,567	1,773	-1,939
o Eliminate legal services, community services, Jobs Corps and weatherization	-564	-777	-873
o Sub-total	-4,104	-6,311	-7,882
Grand Total: Means-Tested Benefits and Social Service Programs			
o Current services baseline	$91,941	$96,623	$102,509
o Proposed savings	-4,476	-7,114	-8,997
o Percent reduction from baseline	5%	7%	9%
o Share of total budget savings	9%	9%	9%

* Disadvantaged and Handicapped Education; Employment and Training Block Grants; Older Americans Employment and Services; Head Start; Maternal and Child Health; Health and Social Services Block Grant; Foster Care; Adoption Aid and Child Welfare; Handicapped Rehabilitation and Low-income Energy.

Other Non-Defense: What Public Sector Functions Can We Afford and Which Do We Need?

- 1986 baseline spending for all of the other public sector functions -- ranging from harbor dredging to health research -- is $211 billion. It represents the accumulation of commitments made over decades based on ad hoc rules regarding appropriate Federal activities and political responses to every manner of special interest pressure.

- We have now arrived at the day of reckoning: we can't afford it all and must make fundamental choices between where we spend and where we save. The Administration's budget does not shrink from that difficult task. It proposes to eliminate two-dozen programs and reform dozens more based on clear and consistent rules for valid and no longer affordable public sector functions.

- Savings in this budget component total $30.3 billion or nearly 80% of the 1986 non-defense total. Over five years, savings in this component total nearly $300 billion. The Administration's plan offers the first comprehensive reappraisal and restructuring of the public sector functions of the Federal government in decades based on the following principles of choice:

    - Purely local economic development subsidies and fiscal aid are no longer affordable and produce few net national benefits. These programs should be eliminated:

        - General Revenue Sharing is an efficient grant mechanism -- but is neither affordable nor makes sense given the relative fiscal health of state/local government compared to the Federal budget hemorrhage.

        - Local development subsidies including UDAG, EDA, Appalachia, TVA development, rural development and sewer grants primarily serve to intensify the competition for investment and jobs among localities in an arbitrary and nearly random manner. Localities desiring to offer subsidies to attract investment should pay for them with their own tax dollars.

        - Mass Transit capital and operating subsidies should be financed with local taxes if uneconomic investments and subsidised fares are desired. Current Federal subsidies are being siphoned off in excessive transit wages, operating inefficiencies and over-built systems. Continued subsidization is neither affordable nor fair and will not stop the decade's long decline of Mass Transit services.

- Major benefit programs that have expanded well beyond their original purposes or promises should be pared back and reformed.
  - The cost of the veterans health care system could triple over the next fifteen years unless eligibility for free care is limited to disabled veterans and the needy. The Administration proposes an income limit of about $15,000 per year, to recover costs from the insurance companies of veterans who are served, and to gradually shift system resources away from over-built in-patient care facilities to skilled nursing and outpatient care.
  - Student grants and loans now cost $8 billion per year, go to 50% of all freshman students, and provide benefits to a wide-range of middle and upper income families. The Administration proposes to cap total benefits at $4,000 per student, eliminate the $3,000 GSL subsidy for families above $33,000, and tighten the independent student loophole. We can no longer afford to subsidize colleges in the guise of helping middle and upper income students finance "high-cost" educations.
  - The Federal Civil Service Retirement System provides the richest annuities in the nation and costs nearly $25 billion per year. The Administration proposes to phase-out overly generous early retirement, reduce the annuity calculation base (High-5) and limit COLA's for upper income annuitants.
- The time has come to curtail unjustified business, commerical or regional subsidies. The Administration's plan would eliminate or sharply pare-back unjustifiable public sector activities in the following areas:
  - Reform farm price supports and cap subsidy eligibility at $20,000 per producer and non-recourse loans at $200,000 per producer.
  - Eliminate Amtrak, the SBA and Export-Import Bank direct loans.
  - Require navigation users to pay 70% of the cost of dredging and construction services provided by the Federal government.
  - Phase-out the REA subsidized loan programs and reform the debt repayment system for Bonneville and other Power Marketing Adminstrations.

COMPOSITION OF NON-DEFENSE SAVINGS
(billions)

	1986	1987	1988
Social Contract			
o Baseline spending	$289.3	$310.4	$333.9
o Savings	-4.2	-6.5	-8.5
Safety Net and Related Social Services			
o Baseline spending	91.9	94.6	102.5
o Savings	-4.4	-7.1	-9.0
Other Non-Defense			
o Baseline spending	211.3	220.7	230.2
o Savings	-30.3	-50.6	-62.2
Non-Defense Total			
o Baseline spending	592.5	625.7	666.6
o Savings	-38.9	-64.2	-79.7
o Other non-defense share of total savings	78%	79%	78%

o Impact of the Administration Plan on Non-Defense Spending Claim on GNP

	Actual		President's Budget		
	1980	1985	1986	1988	1990
Social Contract	6.5%	7.1%	6.8%	6.6%	6.5%
Safety Net/Social Services	1.9%	2.2%	2.1%	1.9%	1.7%
Other Non-Defense	7.4%	5.7%	4.3%	3.4%	2.9%
o Total Non-Defense	15.8%	15.1%	13.2%	11.9%	11.2%

BUDGET IS NEGOTIABLE

Chairman DOMENICI. I am almost reluctant to ask the first question that I have, with your detailed explanation and impeccable logic.

Is this budget negotiable, Mr. Stockman? If it is not, we might as well quit.

Mr. STOCKMAN. Mr. Chairman, I can only say our collective experience suggests it is. For 4 years, we produced budgets, and they were never the same when they came out the pipe as they were when they were put in.

On the other hand, to say that you can throw this plan away and work entirely on the tax side is not negotiable. To say that you can somehow solve this problem out of defense is not safe or prudent. So in the main, I hope you will look carefully at both the details and the logic of what we have laid out, because it best accords with what we need to do for the country.

Chairman DOMENICI. You addressed a great deal of your testimony to the notion of a defense freeze. Would you tell the committee, if you have the numbers, how much we would save in outlays, and how much would still be required to get to the $51 billion outlay savings if we did the following: froze defense budget authority and froze all other programs' budget authority, froze all cost-of-living allowances, and took your definition of a freeze of Medicare, which is a provider freeze as contrasted with a natural freeze on expenditures?

Mr. STOCKMAN. Well, Mr. Chairman, if we finally worked all that through—and there would always be some exemptions—I have heard all of you talking about not putting the means-tested entitlements in it and so forth—you could on paper get $38 billion if you did everything as a practical judgment. Knowing where various members of this committee stand, you could get $30 billion, probably at best, with a freeze on everything, including defense, in 1986, in pure outlays. That is way short of the $50 billion, but the other point is even more important. By the third and fifth year out, you are not close to getting even $100 billion in savings. So therefore, you will not take the budget off the path that it is on. You will be stranded at near $200 billion, if you simply do a freeze, even if it is across the board.

NO SUBSTANTIAL CUT IN DOD PROGRAMS OVER LAST 5 YEARS

Chairman DOMENICI. Now, Mr. Stockman, Cap Weinberger, the Secretary of Defense, tells this committee and tells all groups of Congressmen that he speaks with, that we can only look at the defense budget 1 year at a time. He has recommended 5.8 percent real growth for fiscal year 1986, and he says he cannot predict outlays for the next year and the next year and the next year, because the world situation changes.

Am I correct when I say that substantially no programs requested by the Department of Defense of any significance have been cut in the last 5 years? Is that correct?

Mr. STOCKMAN. That is basically correct, Mr. Chairman, although obviously, there have been some pretty good fights about things like the MX and lesser ones elsewhere.

Chairman **Domenici**. So that when the Secretary of Defense talks about having substantially reduced defense costs, he does not mean that there has been any change in a game plan for weapon systems, strategic or conventional, or manpower requirements. Is that correct?

Mr. **Stockman**. Well, I think if you use the "substantial" in a broad sense, you are right. When you get down to the micro details of the budget, I am sure that there are many technicians that can demonstrate to you that some costs have been borne as a result of delaying something or not providing quite the funding that was requested.

Chairman **Domenici**. I understand.

Now, Mr. Stockman, if I have learned anything from your lengthy discussion here, it is that the defense budget is dictated year over year. In fact, it may be dictated 3 or 4 years in advance by the programs that are funded. This is true unless you seek to actually change those programs or change the policies of the Defense Department as to where they are going in the outyears.

Is that correct?

Mr. **Stockman**. Well, that is true, Mr. Chairman. Once you start a production line running, it is not very smart or practical to produce two planes a year. And therefore, in a sense, once we approve a new system, because we have a need, we have a mission to be fulfilled, you can count on at least a minimal level of acquisition and therefore cost, over the planned production cycle for that system.

WORLD EVENTS COULD CHANGE OPERATING SIDE OF DEFENSE NUMBERS

Chairman **Domenici**. But world events do not change the trend line and have not changed it at all over the past few years. It is the policy decisions that you make in a given year that the Defense Department interprets in terms of funding in the outyears; it is not world changes that have pushed spending up, but policies that are in place.

Is that correct?

Mr. **Stockman**. Mr. Chairman, I think that is basically true on the investment side. The programs that we are putting into R&D, what we have in procurement, is not likely to be dramatically affected by world events unless it was truly a world crisis.

On the other hand, on the operating side, the tempo of activities, what we are running through the system in terms of fuel, spares, and consumables, can be affected by world events, clearly, and that would change that part of the defense number.

Chairman **Domenici**. We have had a history in the Senate of taking care of Grenada/Middle East-type world changes that you have just described by way of supplemental appropriations, so they have been small and have not been in that trend line that they have set over there at the Pentagon as long-term policy.

Is that correct?

Mr. **Stockman**. That would be correct, Mr. Chairman. Other than a major-scale event like Vietnam or Korea, the change in the numbers probably would not be large for smaller peacekeeping operations.

OUTYEAR PREDICTIONS ALMOST IMPOSSIBLE TO MAKE

Chairman DOMENICI. Well, I am not presently committed to any proposal. Your recap has enlightened this Senator more than I have been enlightened by the Secretary of Defense, in all of his appearances here. But if you wanted to reduce defense outlays in the outyears in a predictable manner—let us say you want 3 percent real growth for 3 successive years—what you have just told us is that it is impossible, unless the Defense Department decides to change its policies, consistent with some mandate of a three-three-three. If that was the mandate of Congress, they would have to do it all at once. It could not be done 1 year at a time.

Is that correct?

Mr. STOCKMAN. Mr. Chairman, I think that is the basic case. This defense budget has a multiyear dynamic, and if you are dissatisfied with the funding costs at the present and a couple years ahead, then you are going to have to go to the basic drivers in the system—the force structure, the systems that you have under acquisition, the missions that you have laid on the defense establishment that generate the need for these kinds of forces and weapons—and have an argument about that, and see what you are willing to give up, and how it can be fitted in some priority basis under a different envelope.

But I would just say to the committee that for all the defense debates that I have heard and all of the complaining that people make to me on the grounds that somehow, maybe I am more sympathetic, I have not heard any reasoned, cogent, systematic approach to that kind of alternative for the last 2 or 3 years.

If I came into this committee and said, "The Food Stamp number is too big; it is $11 billion, and I am going to cut $3 billion out of it," you would crucify me in a moment until I laid out precisely where the benefit was going to be changed, which eligibilities would be eliminated or modified, and precisely where the burden of that cut would fall.

But somehow, we get to defense, which involves the fundamental security of this country, and somebody says, "Cut the number by $20 billion; it is too big," or "Freeze it; cut $40 billion, it is too big," and nobody has to lay out all of the kinds of detailed allocations of where those adjustments are going to take place and what the impact is when you make them.

I would urge this committee to stop this futile debate over the defense number, get into the guts of it, see where it is going for several years, whether you agree with it or not, and translate what you want to do into some numbers that can provide an alternative, if you think that is necessary. But until that is done, I do not think we have a very useful debate, and we have not resolved the question of how much we need in the total spending envelope for defense in the years that we are working on.

Chairman DOMENICI. Well, my time is up and I am going to yield to Senator Chiles, but I would suggest to you that you made some assumptions here today about our level of knowledge about what is going on. You are assuming that everybody up here must have stamped their approval on it and said we understood it.

The problem is, if we cut $8 billion in this committee in defense budget authority, we are not permitted to go into the details. We thought we saved $8 billion. It turns out we did not save anything, because that $8 billion would have been saved anyway because the energy cost did not cost as much as estimated, or because inflation went down, or because Congress changed the pay in another bill over what was projected.

So we do have a very difficult job, and I thank you for the explanation and yield to the Senator from Florida.

Senator CHILES. Secretary Weinberger has us in this Catch-22. You cannot do anything this year, he says, because of the forces that are in place; we cannot make any cuts this year, if we do, we would have to cut one or two divisions. And yet he refuses to talk about anything more in any future years. So it is an impossible situation.

I think you have phrased it very clearly. We are going to have to look at 2- and 3-year estimates and projections.

Mr. STOCKMAN. Yes.

NET INTEREST EXPENDITURES SHOW EXPLOSIVE GROWTH

Senator CHILES. In the last several years, we have seen an explosive growth in net interest expenditures. Indeed, in the President's budget proposal, it is astounding to note that in the coming fiscal year, net interest outlays are going to exceed outlays for all nondefense discretionary programs. You propose to cut those nondefense discretionary programs by $25 billion, but we only manage to cut interest payments by $3 billion.

So the growth in net interest outlays would be even far worse if, as Mr. Grassley has said, you used realistic economic assumptions. It will grow about $30 to $45 billion in the next 3 years.

It seems to me that the interest costs really are squeezing out our ability to do anything that we want to do, whether it is increasing defense, or technology and training, or reducing the deficit.

Doesn't it seem to you that we would reap a big bonus if we did the right job now, if we quit nibbling away at the deficit, and if we got the interest down to where it would actually not be growing in the outyears?

Mr. STOCKMAN. Well, Mr. Chiles, that is precisely right. We are now chasing our tail, so to speak. We are in a vicious circle where, the longer we delay action and remedying this structural imbalance in the budget, the worse it gets, because we pile on huge amounts to the national debt that have to be financed, with increasing risks over time that they would have to be financed at very high interest rates, when finally, the market becomes clogged.

So you have hit it on the head, and this number now is so big—debt service of nearly $150 billion in 1986, compared with a little over $50 billion in 1980. When something that buys you nothing triples, then it seems to me you have got a pretty stark and dramatic indication of the magnitude of the problem that you have.

PRESIDENT IS READY WITH HIS SUPPORT

Senator CHILES. One of the things I find out when I talk to any group, about the cuts is this. They ask me if these cuts are made, if our program is cut, are you going to be able to assure me at the end of that exercise that you have solved the problem? Will the deficits be getting smaller as a result of our sacrifice?

You started this exercise off saying we had to go from 5 percent to 2 percent. That is very sound. But you did not get there. And no one else has seemed to have found a way to get there yet soley because of cuts on the spending side. I think the only way we are going to be able to rationalize the pain is if we come up with a package that really gets this job done. We are going to need the President's leadership on this. You won't get the job done if you have a 13-percent increase in defense. You are not going to get it done if you do not touch certain of the social programs; you are not going to get it done, if when you get all of this spending down, you refuse to look at something on the revenue side.

Will we have the President's help if we really want to try to do the job?

Mr. STOCKMAN. Well, Senator, I think you have to assume that you will. This budget was not simply sent up here to dispose of a simple requirement in law. It was because the President believes that the time has now come to make these changes, that we cannot live with these deficits, and he is ready to go to bat for this plan or any adjustments that we work out to try to put together something that is enactable.

But I think you have to understand that if it is not enactable, if it does not get put into law, if we do not start changing the spigots that cause the spending to occur, all of this is a futile exercise, another paper plan. So of course, that support will be there.

Senator CHILES. Thank you.

Chairman DOMENICI. Senator Kasten?

FARM POLICY REQUIRES UNDERSTANDING OF COMPLEXITY OF AGRICULTURE

Senator KASTEN. Mr. Chairman, thank you.

I would like to shift if I can to the subject of agriculture. Nineteen eighty-five is going to be a key year for American agriculture, and the decisions that we make in Congress, first of all on the budget, but also over the next several months on the farm bill, are going to determine the shape of farming in America. No area of the Government can be exempt if we are to succeed in getting the deficit down to manageable proportions, and agriculture obviously must be a part of any kind of a program. But yet, I do not believe we can afford to balance the budget by singling out for disproportionate cuts any one segment, and an attempt to do so, particularly in the area of agriculture, in an area where people are already hard pressed, is, I think, bad policy.

So I believe that we have got to recognize that the making of successful farm policy is more than a question of juggling numbers in the budget. It requires an understanding of the complexity of American agriculture, particularly the medium-sized and the smaller farmers, and also the industries that service it.

It also requires, I believe, an understanding that the mistakes that we made in the 1981 farm bill cannot be corrected all at once. And with all respect to our witness today, Mr. Stockman, successful farm policy, I believe, cannot be made only at the Office of Management and Budget. We have got to also have the Agriculture people in mind.

FARMERS IN NEED OF EMERGENCY DEBT ASSISTANCE

We have been discussing the farm credit crisis over the past couple of days. All across the country, farmers today are in desperate need of emergency debt restructuring. If help is not forthcoming I believe that thousands of farms and the banks that finance them will go under in the next few months, possibly even in the next several weeks. This would devastate much of rural America and, I believe, create a situation in which it will be impossible to achieve any of the goals that you have outlined with regard to the farm or agriculture section of the budget.

Now, the administration's emergency debt restructuring program, discussed last week, I think can be an important step in the right direction. In order to be successful, I think first it has got to provide farm lenders with the option of writing down interest rates sufficiently to allow efficient managers in temporary loan trouble to provide sufficient loan guarantee authority to meet demand; second, to include procedures which would encourage forebearance toward farm borrowers by the loan examiners, and third, to provide for enough personnel to administer the loan guarantees successfully.

Now, the outlines of the programs that we discussed last Thursday and Friday, I think are basically consistent with those points. And a debt restructuring program with these features, I think has a good chance to save many of our best farmers from a fate brought on by circumstances, in many cases, beyond their control.

But I think that chance will be lost if the administration does not act quickly. And when I say "quickly," I mean in the next days, or certainly, weeks. Announcing the details of the program, frankly, in the next few days would be a good start.

What is the timetable for the emergency debt restructuring program from the Administration?

NOT TAXPAYERS RESPONSIBILITY TO REFINANCE BAD DEBT

Mr. STOCKMAN. Senator, let me first observe that we built our way brick by brick to a trillion-dollar budget, brick by brick to a quarter of a trillion-dollar deficit, by responding to desperate needs, emergency crises, without any explanation or reason as to why it was the Federal Government's responsibility in the first place.

For the life of me, I cannot figure out why the taxpayers of this country have the responsibility to go in and refinance bad debt that was willingly incurred by consenting adults who went out and bought farmland when the price was going up and thought they could get rich, or who went out and bought machinery and production assets because they made a business judgment that they could make some money.

Now, it turns out that the land prices could not go up forever, and did not, and all kinds of loans for land have now gone bad because the collateral has collapsed.

Why do the taxpayers have the responsibility to bail out through loan guarantees, which will create costs down the road, that kind of speculation?

If that had been caused in the first place by New York banks and other city slickers who tempted those farmers with money to buy land, it would be one thing. But I can prove to you that the entire land boom from 1977 to 1981 was financed by the farm credit administrations, particularly the land banks, which are owned and controlled by the farmers, who made loans to each other to buy each other's land. And now that has all gone sour, because it was based on unsound economics, and because it was propped up with Federal price supports, and cheap credit, which could not be justified.

I do not see why we have the responsibility to step in, why it is any different than small businesses, the hundreds of thousands of them that go out of business each year, the 1,000 savings and loans that have closed since 1980, the hundreds of thousands of people who have lost their jobs in the auto industry when it had to shrink down in order to become competitive again—I do not see the difference. And if we are going to respond to each of these areas with new programs and subsidies, that trillion will keep growing, and that $200 billion of red ink will keep flowing.

We are probably going to have to do something, because the drumbeat of political demand is so great, and because basically, we are threatened with a kind of blackmail situation—"Do something for us now to refinance all this bad debt, or we are not going to allow the farm program to be reformed."

I think it is a sad day that those kinds of threats are being made, but frankly, they are, and so we will end up probably having to do something. But it is sure a bad way to start the process of trying to get our fiscal house in order, where the one group that has the least claim on the budget—farming is a business, and it does not need subsidies any more than any other business—the one group that has had the greatest budget excess in the last 5 years, $60 billion in farm subsidies in the last 5 years, starts the log rolling by demanding more. That is a little bit discouraging.

BULLET MUST BE BITTEN ON OTHER PRICE SUPPORTS

Senator **Kasten**. Well, if I remember correctly, last year this administration asked Congress and particularly, the Foreign Operations Subcommittee of the Appropriations Committee, for $8.4 billion for the IMF. You got it. And, essentially it was a bail-out of the big banks. You mentioned priorities. I think that we have got our priorities wrong, if we are bailing out the IMF and are unwilling to come to any kind of rescue of small- and medium-sized farms.

We have already appropriated the farm money—I think it was $500 or $600 million—in the administration's announced program this fall. Those dollars have not been paid out.

When is the administration going to announce a debt restructuring program using at least the available funds? If I remember right, we have got $608 million which essentially are available, according to the meetings that we held last week.

Mr. STOCKMAN. Well, trusting that we will get some help when it comes time to biting the bullet on dairy price supports—they are clearly too high; we cannot afford to spend $2 billion stockpiling cheese—if we get some help in getting the wheat price supports down—at $3.30, where they are now, we are holding up prices for the rest of the world and producing competition for ourselves—when we get some indication, and I hope that we have had that, and can trust that that will be the case, that we are going to bite the bullet on this farm program and protect in the transition, Senator, the small producer with a direct income payment of $20,000 a year—that is more than we give anybody on welfare; that is more than we give any old people who do not have anything else—$20,000 a year for the transition, and when we get some support and some encouragement on that proposition, we will move forward on the credit bail-out.

Chairman DOMENICI. Your time has expired.

I might suggest something since I know we have a number of Senators here interested in the agricultural situation. I have conferred with Senator Chiles, and I will modify the schedule for the week of February 19, so as to provide forum with reference to the farm programs. We will attempt to accommodate Secretary Block's schedule and get him here to testify, even if it is some afternoon for 2 or 3 hours. It is going to be difficult to accommodate both him and us, but we will try to do so.

Senator Metzenbaum?

BUDGET INDICATES ADMINISTRATION'S THOUGHTS

Senator METZENBAUM. Mr. Chairman, thank you.

I think, Mr. Stockman, you indicated that you have tried to give us a basic picture of the problem. And I think that it is a little complicated for the average American, and I would like to give a basic picture of the problems as I see it.

The budget is 2,054 pages long, and it is an indication of what the administration thinks is important and what it thinks is not. Is it fair?

That depends on what the President has put on the chopping block and what he has left off. The Nutrition Program, that is obviously on the chopping block. This budget slashes nutrition programs for pregnant women, babies and schoolchildren. The President says that is all right.

Education—cuts in student loans for middle-class families; less help for disadvantaged youngsters and the handicapped. The President says that is all right.

Agriculture—farmers get whacked about $22 billion over 3 years. President Reagan once called farmers "miracle workers". Now he tells them to perform their miracle in another line of work.

Medicare—senior citizens must pay higher premiums, 40 percent higher. What do they get in return? Even fewer benefits. That is fine, according to the President.

Veterans—the President has put their health benefits squarely on the chopping block.

And the poor—they get hammered $35 billion over a 3-year period that provide health care, food, and housing.

No problem, says the President. Put them on the table.

So look, Mr. Stockman—I do not want to speak behind the blocks——

Mr. STOCKMAN. I am losing sight of your point, Senator. [Laughter.]

Chairman DOMENICI. As a matter of fact, I was just going to ask you if you would please stand up, but you beat me to it.

SAFETY NET ON CHOPPING BLOCK

Senator METZENBAUM. You will see my point, Mr. Stockman.

Look what you have got on the block. You have got the poor, the elderly, veterans, students and children—the same people you have gone after the last 4 years—4 years ago, President Reagan said he had a safety net. Now you have got that safety net on the chopping block and everything else off. You go after middle-income Americans, cut social programs, but leave the big dollars in the budget.

Look at what is off the table, Mr. Stockman.

Defense—now the President says he has cut defense. But when the President calls a $30 billion increase in 1 year a "cut," something strange is going on.

And what about tax breaks for large corporations. If you remember, you addressed yourself to that very subject in an Atlantic magazine article. President Reagan says it is off limits to ask these huge corporations to contribute a few dollars. I call that "corporate welfare."

Examples: The Government hands out in corporate tax subsidies, and then it collects corporate revenue. More than half of this country's biggest firms earn $57 billion—$57 billion—in profits since 1981, but paid not 1 cent in Federal taxes, income taxes. Instead what happened? The Government sent them checks totaling $5.7 billion. Corporate welfare is General Electric earning $6.5 billion in profits, paying no taxes, and receiving that refund check over there for $283 billion.

Now, this is not a refund like the average taxpayer gets after paying his taxes. These are checks corporations get after paying no taxes.

The President says the corporate welfare budget is off limits; we cannot cut that. So what is the result? The result is we take funds from social programs to finance give aways to big business.

Look at Medicaid. Over the past 3 years, you cut Medicaid $3.2 billion, and during the same 3 years, you paid out in refunds the same $3.2 billion to 65 of the wealthiest corporations in America.

Job Corps: You cut $85 million—not much, but a lot—and 2,000 teenagers wound up being back on the street because of that cut.

TransAmerica got the same $85 million from the U.S. Treasury.

You cut Head Start a small amount, $1 million, throwing little children off the program, but American Standard picked up $1 million in a tax refund, notwithstanding their profitable operations.

So here we go again, Mr. Stockman. You come here this year, the same in the past, as you have every other year, with your load of pain, suffering, for the elderly, the young, the poor and the sick.

PUT DEFENSE AND CORPORATE WELFARE ON THE TABLE

My message to you and to President Reagan is: Put defense on the table. Put corporate welfare on the table. Then we can have a budget that actually comes to grips with the deficits that are threatening this Nation.

All of us want to help solve the problem. But I think we have got to have everything on the table if we are going to truly work together in order to achieve the objectives that I think every Member of Congress, and hopefully the President and you, feel is so important as far as the future of this country is concerned.

Mr. Chairman, I do have additional questions, but I recognize that my time has expired.

Mr. **Stockman.** Mr. Chairman, if I could respond——

Chairman **Domenici.** I just want to make a point. You used all your time, Senator Metzenbaum, and you did not even ask a question.

Senator **Metzenbaum.** As a matter of fact, it was my understanding that the chairman had indicated that we could use our time for an opening statement or questions, and so I will come back this afternoon for questions.

Chairman **Domenici.** Sure. You are absolutely right.

Mr. Stockman, do you want to respond quickly?

Mr. **Stockman.** Well, Mr. Chairman, let me commend Senator Metzenbaum for performing some agit-prop in its finest manner.

But I will put some of those things on the table, if he will not take them away. If I could have my assistant go up there, we will put "corporate welfare" on the table first. If we could get the "corporate welfare" item, we will get that right on the table.

Chairman **Domenici.** Put it over on your table.

Mr. **Stockman.** Yes, I want it on my table. [Laughter.]

COMPANIES WILL PAY TAXES UNDER TAX REFORM PLAN

Mr. **Stockman.** All right. You mentioned GE. A good example. They have not paid any taxes in 4 years, and if you support the Treasury tax reform plan, they will. They have gotten $1 billion worth of Export-Import Bank direct loans after paying no taxes; if you support the budget, they will not. They are one example of "corporate welfare," and there are many more that I could make.

The point is that 57 companies that you mentioned that have not paid taxes have not paid taxes because of the way the tax system is structured now. If we implement the Treasury reform plan, including the elimination of the investment tax credit—one form of welfare—the modification of ACRS, another form, those companies will pay taxes, and they will be contributing their fair share. So if we could set that one aside for a moment.

Nutrition. Let us get that one up on the table, because I am tired of hearing about it. Now, the fact is, we are not cutting any nutrition programs in this budget.

WIC, you mentioned. There are 3 million people today getting WIC services, double 3 years ago, and quadruple what we had in 1980. We have proposed in this budget to fund 3 million WIC beneficiaries, more than we ever have before, and to keep it funded for inflation on out to 1990, serving 3 million people.

The other thing that you might be referring to is the School Lunch Program. No change in this budget for the low income who receive free lunches under 130 percent; no change in this budget for the lower middle income that need help, 185 percent of poverty to 130, $19,000 income. The only thing that we are proposing to do, Senator, is take two dimes away from those above 185 percent of poverty, $19,000, $38,000, $119,000, that can easily pay two dimes for the school lunches of their children.

LOW-INCOME FARMER WILL GET HELP

Finally, let us get agriculture on the table, if we can get that one up here. We discussed it before, but I for the life of me have a hard time understanding why you are against corporate welfare for the corporations, but not against the same kind of welfare for farmers, or so it would sound.

The problem right now is there is no limit that is effective on the deficiency payment. There is no limit on the availability of nonrecourse loans. And so, if you look at what we have spent over the last 5 years, $60 billion, on defaulted loans and deficiency payments, over half of it has gone to farm operations with $250,000 a year in sales, up into the millions. And we are proposing to cut it off at $200,000 on the free loans and $20,000 on the straight grants.

We are going to be helping the lower income farmer, the smaller sized operator, but we are going to cut out the welfare for the big boys who say they like the marketplace and now will be given a chance to try it.

EDUCATION PROGRAMS NOT BEING CUT WHERE THERE IS NEED

We could go on down the line with some of your other building blocks, but the answer would be the same. We are not cutting any of the education programs where they are need—disadvantaged, handicapped, bilingual—those are not being cut. We are freezing them, yes. But Senator Chiles has proposed to do that, and so have half of the members in your party. The only things we are cutting are, for instance, GSL subsidies. If you are above $33,000 a year, you can still get a loan, but without the interest rate subsidy. Now, that is worth $3,000 on a lifetime basis to someone who gets it. I do not think we can afford to give $3,000 to someone from a $50,000 or $100,000 family that wants to go to Harvard.

Senator, those are the kinds of things we are doing, those are the kinds of building blocks that we have on the table. And I wish that you would look at it a little more closely before you conclude that everything we are doing is wrong, and that everything we are doing is inconsistent with what you think. Many of them are consistent, and we would like to have your help.

Senator **METZENBAUM**. Mr. Chairman, I do not want to debate, and have no right to. But it is my understanding that the whole question of tax reform is not before the Budget Committee as presented in this budget. Am I wrong?

Chairman **DOMENICI**. The Senator is correct.

Mr. **STOCKMAN**. But it is before the Congress, and there will be due opportunity to correct it this year.

Senator **CHILES**. Has the President sent that up?

Mr. **Stockman**. No, that hasn't been sent up yet. But I am saying the Treasury plan is one way——

Senator **Chiles**. But has the President endorsed it?

Mr. **Stockman**. Well, wait a minute. You said the President——

Senator **Chiles**. Well, you said it is before us. I just want to know——

Mr. **Stockman**. Wait a minute. Let me respond. Why don't you endorse it? Every one of the K Street lobbyists who promote corporate welfare in America are dumping all over it, trying to tear it apart. And it will not be around many more days unless some of you who are against corporate welfare get behind it and say that corporations ought to pay taxes, 33 percent of their income, without all the loopholes. That is what this plan does. We will be there when the time comes, and I hope you are helping us along the way.

Senator **Metzenbaum**. Send it up. Send it up, Mr. Stockman.

Chairman **Domenici**. Senator Grassley, we went to Senator Kasten in your absence, but you are next.

Senator **Grassley**. Mr. Stockman, one of the things that you probably remember that I am interested in is defense. And I see here, on one of the explanations you have about a freeze, it says a freeze would require a reduction of flying hours, steaming days, training time, depot maintenance, spare parts availability, and other force operations. Freeze advocates have not analyzed or explained the consequences of the cuts in this area.

That is on page 10.[1]

Mr. **Stockman**. That is right.

READINESS AND CAPABILITY HAVE INCREASED

Senator **Grassley**. We have had a 25-percent increase in constant dollars—that is a 4-year increase—of budget authority between the Carter years, 1978–1981 and the Reagan years, 1982–1985.

Now, what have we gotten for that 25-percent increase? We have gotten 2½ fewer flying hours for the Army, only 1½ more steaming days per quarter for the Navy, one-half hour less for Navy flying, and only 2 more flying hours per month for the Air Force.

Now, I do not accept what you said here that we cannot prove how we are going to accommodate that. But for a 25-percent constant dollar increase in budget authority for defense, do you think we are getting our money's worth when, for that 25 percent increase, we only get 2½—or, we actually get fewer flying hours for the Army, only 1½ more steaming days per quarter for the Navy, and I will not go through it all again, but that is despite 25 percent more money, in constant dollars?

Now, have you made a case that more money is going to give us more of this readiness and more capability?

Mr. **Stockman**. Yes, I have, and I think the numbers that you have given are very misleading. If you go back to the average for 1978 to 1981, that reflects oil prices that were far lower than they are today, even though oil prices have come down.

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[1] See p. 36.

When you run airplanes, when you run ships, you put a lot of hydrocarbons through them. So we need more budget authority as a result of that, and the average price level that we are paying today in real terms is higher than it was in the base period that you are measuring.

The second thing is you are using ratios in terms of flying hours per aircraft, and you have not recognized that both the numerator and the denominator has gone up. We not only have more hours in the numerator; we have more aircraft in the denominator. Therefore, we have had to spend more money simply to keep the tempo of operations the same when we are improving the force structure and the assets that we have in the operational inventory.

I will look at those numbers, but I think you have got some very misleading conclusions drawn out of comparing some apples and oranges.

STATE-OF-THE-ART EQUIPMENT MORE COSTLY TO OPERATE

Senator **Grassley**. Well, even the Defense Department says that this report, on "Improvements of U.S. War Fighting Capability," points out that "The increased operating costs of the more complex equipment entering our inventory is a major cause for this disturbing state of affairs."

Mr. **Stockman**. Well, that is true, Senator, but that is because we are replacing older, more simply, less costly to operate equipment with state-of-the-art equipment that we need to meet the threat. Of course, it costs more to operate an F-14 than it does an F-4. But the problem is that we have concluded a long time ago that we cannot meet the Soviet threat with F-4's—and on down the line, you deal with that situation.

You cannot purchase the security that this country needs at a constant dollar cost over time if the other side is increasing the degree of the threat on an area-by-area, weapon-by-weapon, force-by-force basis.

Senator **Grassley**. Well, I have heard all of those arguments, and I just have to say they are not acceptable. But let me go to another point.

I would like to have your judgment on a freeze of defense. If Congress were to freeze defense outlays, would you recommend a BA freeze or an outlay freeze, and why would you choose it and do you think that a BA freeze is technically doable?

FREEZING OUTLAYS WOULD CAUSE NATIONAL SECURITY CATASTROPHE

Mr. **Stockman**. Well, let me answer the first question. An outlay freeze, given what you have in the pipeline now—there is 250 billion dollars' worth of spending authority in the pipeline—it has nothing to do with what you vote this year. It is going to generate outlays in 1986. If you tried to freeze outlays, you would have a national security catastrophe.

Even if you freeze budget authority, your second choice, outlays will rise $20 billion from 1985 to 1986. Now, if you try to freeze outlays at $246 billion, you have got to cut another $40 billion more in budget authority from where you were last year. If you try to cut $40 billion in budget authority, you simply cannot do it without wholesale deactivation of the forces and firing people in sight everywhere, regardless of what would happen to our security posture. You would have to put every ship in port, every plane on the ground, and simply spend 1 year naked in terms of the security requirements of this country.

You do not want to do that, I am sure.

BA FREEZE IS DOABLE, BUT BE CAREFUL WHAT YOU CUT

Senator **Grassley**. Well, is a BA freeze technically doable?

Mr. **Stockman**. A BA freeze is technically doable because that is what Congress controls, the budget authority appropriated for 1986. But what I suggested in my testimony is you want to go over very carefully what you would have to give up in the 29 billion dollars worth of additional funding that we have in our request above a BA freeze of $285 billion, the number for 1985.

And as you go through that, you are going to be giving up some things in the classified area that we cannot talk about; you are going to have to give up some things in the new systems areas that I laid out on a couple pages back in here; you are going to have to have operations and maintenance funding at the same level as last year, which will mean fewer flying hours and steaming days—it has to; things are going to cost a little more this year than they did last year. You are going to have to give up a lot of things, and you need to lay out in a fairly detailed analysis what you are going to give up and whether you think that is worthwhile.

I know that you have been a great advocate of reform, and I commend you for that, because there are some things that we cold buy cheaper, there are some operations we could do less expensively than we do now. I would just caution you, though, that those reforms would take several years before they even have a budget authority effect.

If you go to procurement reform, for instance, you cannot lay that onto contracts that are already in production. It will have to be on new systems that might be starting. We are going to start the C–17 in several years. Lay on your reform on that one, but it will not save any budget authority in 1986.

So, I just hope you recognize that you ought to keep pushing for these reforms, but in terms of getting the dollars out in 1986, most of them will not have much effect.

Chairman **Domenici**. Senator Johnston?

DEFENSE BUDGET HAS ALL KINDS OF FAT IN IT

Senator **Johnston**. Thank you, Mr. Chairman.

Mr. Stockman, for the last 4 years, I have voted for almost every freeze and budget cut that has come on the floor or in the committee. I voted to cut Social Security COLA's back in calendar 1981, when we would reduce it from CPI to the wage index. I have proposed my own plans. I have voted for species of taxes. I have voted for just about anybody's plan that I thought was sensible that would get that deficit down.

Now, when I look at this last election and the promises which were made on both sides, I must say that I am discouraged in the outlook for the country. First, because I think taxes are indeed not on the table; and it looks to me as though Social Security has really been taken off the table and unnecessarily so. And now it looks as though defense is really off the table.

As I look at our record, and as I look at this budget, it seems to me we cannot get there from here.

The big growth, really, you say, has been in Social Security, with outlays increasing $18 billion, or 35 percent since 1981. And defense—I mean, I hear these figures about how defense has not grown, and I scratch my head and I say "Hasn't defense outlays almost doubled since 1980; hasn't it gone up from 24 to 29 percent of budget outlays? And I sit there, scratching my head.

So, I must say when I see this budget come down, it looks to me like a political document, that is to say, one in which everybody says, "Well, they don't really mean that. They don't think they are going to get that much for defense, they think somebody is going to cut it. They don't really mean to say that they think they are going to eliminate all of these programs wholesale, savage agriculture," et cetera.

The problem is some of us sit around and say, "Well, where is the leadership going to come from?" I know this defense budget has got all kinds of fat in it. You cannot tell me that it is fair to savage civil service retirement and to let military kids retire at age 38, as the young boy who used to do yard work for us did, and get a full COLA from age 38 for the rest of his life, while a civil service retiree cannot do the same.

Mr. STOCKMAN. I agree with you completely on that, and I hope that the Hill will do something about it.

LEADERSHIP NEEDED ON DEFENSE

Senator JOHNSTON. Well, you know, the Hill has passed legislation to slow down COLA's for people who are old and gray. They passed it twice. That would have saved a great deal of money.

Now, we need some leadership from you on defense. I do not think there is a person sitting at this table who believes you have got to have all this money in defense. We need some leadership, because a lot of these things are not going to happen without the administration leading.

And I can tell you, a number of our friends from that side of the aisle have come by and said, "You have got to come with us on Social Security. If you do not put that on the table, that is the linchpin. Nothing else is going to happen without that."

My answer is, "Unless the President puts it on the table, it is not on the table, and it is not going to happen."

Just yesterday at the White House, House Republicans were telling me they are not going for anything on Social Security—they have been hurt on that before—unless the President says "Put it on the table."

So, you can talk all you want about you have got to have every cent of defense, and you have got to keep Social Security off the table, and that this budget is serious. But I do not think people on this committee believe it. I do not think the Congress believes it. And I think it may be a formula for gridlock, and I hope you can—

well, let me just ask one question. Do you and Cap Weinberger really agree on defense?

Mr. STOCKMAN. Let me take your points. They are good points. We seem to be hung up on this metaphor as to what is on the table or is not. We ought to clarify a few things, just sort of as facts of life that we all know to be true.

DEMOCRATS TOOK SOCIAL SECURITY OFF THE TABLE

One, the House Republicans, or the President, did not take Social Security off the table. The Democratic Party, the Democratic Campaign Committees, the dean of the Democratic Social Security advocates, Mr. Pepper, took Social Security off the table a long time ago, with some pretty severe and irresponsible attacks on what the Republicans or the administration had in mind about Social Security.

And we know that if we get involved in a partisan Social Security battle, the whole thing will fall, and if there is anybody who has got the responsibility to put it back on the table, it is on your side of the aisle. No Democrat, you included, is ever going to be attacked by a Republican for cutting Social Security, and you know it. But as long as that is not put on the table——

Senator EXON. I was, in my last campaign.

Senator CHILES. I was, in my last campaign 2 years before that.

Mr. STOCKMAN. Well, I seriously doubt that.

Senator EXON. It is true. [Laughter.]

Chairman DOMENICI. We will not get into that debate.

Mr. STOCKMAN. Well, I mean, if what I have said are not the facts of life, then I must be naive, because we know who owns the Social Security turf in this political system, and it is the Democratic National Committee and the partisan Democrats who surround it—no doubt about it. And if you want it back on the table, you have got to go to that place and find out whether they are going to be responsible. And that is the truth, and you know it.

YOU CANNOT FREEZE THE BUDGET

Now, on defense, I do not agree, obviously. That is what all this stuff in the paper was about, and we have had fights. But now the President has made his decision. He recognized that I am in the institutional position that I have to defend the budget.

What I was here to do today, though, was to say that I think some of you are unrealistic if you think you can freeze it. You may not need the 314, I will grant that. You found ways to take a little out in the back. But freezing it is a $29 billion question the first year, and a much bigger question in the outyears, and unless some of you are willing to say, "Here is my alternate plan. You know, we are not going to have a 600-ship Navy. We are going to have something else. We are not going to have the rapid deployment response capability that we planned. We are going to have something else. We really do not need a Triad. We can do with the Diad, or a one-legged strategic deterrent."

When you put some of that stuff on the table and the numbers behind it, then maybe you can get a fair debate, and maybe some of those who have a different viewpoint downtown would have something to talk about as well.

So I have to defend the budget, but today, I did not do that. Today I told you why, even in my judgment, I think you cannot freeze it. But there is one area where I will make an exception.

MILITARY RETIREMENT IS AN OUTRAGE

I have not been able to get anything done on military retirement downtown. It is a scandal. It is an outrage. The institutional forces in the military are more concerned about protecting their retirement benefits than they are about protecting the security of the American people. And, when push comes to shove, they will give up on security before they give up on retirement. Now, that is just another true fact of life, and I will probably be in hot water for saying it, but I am going to say it because it was about time it was said. And I hope some of you up here who think the military budget is too big will call in the Joint Chiefs of Staff and ask them what they are going to put in the kitty by supporting a reasonable and moderate military retirement reform plan to go along with what we need to do on the civilian side.

Chairman **Domenici**. Well, I think you just made a bigger news story than Metzenbaum with all his props. [Laughter.]

Senator Symms is next.

Senator **Symms**. Thank you, Mr. Chairman, and thank you, Mr. Stockman.

I want to compliment you on what I think is a very capable statement you made this morning, and what you just said was also very courageous. I appreciated the colloquy you had earlier with your former colleague from the House of Representatives, Senator Kasten here, about the farm program.

AMERICAN FARMER WILL BE BETTER OFF WITH PROPOSED PROGRAM

As you know, I happened to be a farmer before my present occupation, and I think that the administration has proposed a farm program that, if we can weather the political storm, in 5 years, will make the American farmer much better off than he is today.

There has to be a readjustment with respect to the farmers. These real estate prices have been pushed artificially higher than they would produce, and everything ultimately has to be measured in production.

So I for one, support the general thrust of what the administration is trying to do with respect to agriculture, because I believe American agriculture will be better off if they can get away from relying on Federal supply management programs, which simply do not work. We have priced ourselves out of the world market, and we have to get back in competition. I compliment you for your ability to articulate that point.

Now, there is one point that Senator Johnston mentioned that I think should be reemphasized. Most of us are willing to take some more cuts. I think you have come up with a pretty good budget.

One issue that has not been talked about here today is growth. The way we are going to take care of the less privileged people in this country is to have more jobs and more economic growth. One way to achieve that is lower interest rates, and one way to get that is for us all to bite the bullet, and get rid of all the sacred cows in the Federal budget.

You are quite right proposing many programs to abolish. In some instances, some of us may find, for parochial reasons, that it will be difficult to give these proposals 100 percent endorsement. But in general, I support your recommendations to eliminate some of these Federal sacred cows.

With respect to defense and Social Security, is there any way that we could even get a "maybe" out of you today that those two items could be more on the table than they are?

Mr. STOCKMAN. Well, I think those items are so big that they are well-known, and a "maybe" or a "yes" or "no" from me really does not make any difference.

We know how Social Security gets on the table, if it does, and I think I have laid out a challenge for you this morning as to how you get defense on the table. You put a plan together that shows how you are going to do it, and how you can do it without hurting the basic things that we need, and no one has done that yet.

PEACEKEEPER DIFFICULT TO SUPPORT

Senator SYMMS. In a headline in today's paper it says, "Reagan Calls for the Courage to Say No." When I look at the defense numbers—your explanation, incidentally, is one of the best that I have seen passed out here so we could actually see where the dollars go. But when I look at the Peacekeeper, on page 9, just to check your numbers, we spent $4.3 billion last year on the Peacekeeper; is that correct?

Mr. STOCKMAN. Yes.

Senator SYMMS. And the $4 billion—does that complete the 21 missiles?

Mr. STOCKMAN. The $4 billion for 1986 is the sum of both R&D, military construction and procurement, and it includes 48 missiles.

Senator SYMMS. What happens if we scratch that?

Mr. STOCKMAN. If you scratch all $4 billion?

Senator SYMMS. Yes, sir.

Mr. STOCKMAN. Well, you give up the 48 missiles, you stop the R&D program in its tracks, and you eliminate any funding for construction activities that are going to be needed to change the missile silos where they would eventually be put.

Senator SYMMS. The reason I ask the question is that I have had a great deal of concern with the administration about the fact that the Congress appropriated money, to build the Minuteman 3's, which are now sitting in warehouses somewhere. The Minuteman 3's would increase our strategic capability, not as well as the MX, but 15 percent more than at the present.

We also have $18 billion worth of Poseidon boats that are scheduled to be dismantled this June.

I find it rather difficult to vote for more billions for the Peacekeeper, while we are dismantling a perfectly good deterrent in the United States-Soviet strategic standoff.

Those are areas that I think we will specifically have to address with the Secretary of Defense, but I do think there are some places in this budget where we could save some money on defense.

THE MOOD IS HERE FOR CUTS

For example, last year, I offered a budget that froze all civil service pay and all military pay for 3 years and all COLA's for everyone above the poverty level. And that in itself came up with a budget that ended up in the third year with only a $140 billion deficit. If you added some of your cuts to that, I think we could achieve a good budget package—I am more optimistic, I would say, than my colleague from Louisiana, who is pessimistic about this. I think the willingness and the mood is here to do some of the things you are recommending, and then add to it. I think this Congress is going to do it, so I would urge you to encourage the Secretary of Defense to tell us the areas we can cut that will not hurt our strategic and tactical capability, and our ability to carry out our defense mission. You touched on one issue that is very sensitive, of course, and that is the pension program. But I think all Federal pensions should be overhauled, civil service and military. The time has come to stop giving unlimited COLA's to all Social Security recipients—maybe not those on the low end who are less advantaged than others. But there are millions of the 37 million Social Security recipients who would probably be willing to forego their COLA's if they viewed this budget as fair to everyone.

I guess my time has expired, Mr. Chairman.

Thank you very much for a very fine presentation to this Committee. I appreciate it.

[Whereupon, Senator Boschwitz assumed the chair.]

Senator **Boschwitz**. Do you want to respond, Mr. Stockman?

Mr. **Stockman**. Well, Senator, as a former farmer myself, I can say that I am glad to hear that there is one member of this committee who shares the same view as to what appropriate public functions are and what things we do not need in this budget.

Senator **Symms**. You know, if a farmer is going to farm for a living, having real estate that is worth $3,000 an acre that at his death, will be hit by the death tax commissioner, does him absolutely no value. The only people that are helped by having high real estate values are those people who are investing in agriculture with the other funds. But for the true farmers we are better off with lower priced real estate and production that is more in line with the value of it. The administration has targeted a program that will in the long run help the farmer, not hurt him.

Senator **Boschwitz**. Any other comments, Mr. Stockman?

Mr. **Stockman**. No.

Senator **Boschwitz**. Senator Riegle?

Senator **Riegle**. Thank you, Mr. Chairman.

Having listened to the exchange this morning, I want to make a comment and ask two questions.

DEFICIT WOULD RISE TO ALMOST $1 TRILLION

The thing that I am struck by as I listen to this and reflect back over 4 years now of discussions like this is that we really have an incredible 4-year record of budget failure. The deficits over the last 4 years are as follows: 1982, $128 billion; 1983, $208 billion; 1984, $185 billion; 1985, estimated to be $222 billion. This budget is calling for a deficit, if we pass it today just as it is of $180 billion. That would mean that for the 4 previous years, we have added approximately three quarters of a trillion dollars to the national debt, and if this year's was passed today—as submitted— the debt would rise to almost $1 trillion.

Now, I thought Senator Grassley made a good point earlier in challenging the economic assumptions, I am disturbed about that, too. If we were to just do exactly what you have asked for today, we would be seeing deficits higher than the ones that are here.

We have got a continuing hemorrhage of red ink, even if we passed this budget and it came out just as you predicted it would.

I have not heard anybody yet today endorse this package. The closest was Senator Symms, saying that he thought it was a pretty good job done here——

Senator SYMMS. It is good as far as it goes.

Senator RIEGLE. I take it that that is not an endorsement of the package as it is presented today.

Senator BOSCHWITZ. Go ahead, Steve.

Senator SYMMS. Well, I would like it to cover more.

Senator RIEGLE. Well, I do not want to take up my time except to know whether it is or is not.

Senator SYMMS. I would like it to do a little more in the area of Social Security and the Defense Department.

Senator RIEGLE. I have not heard anybody yet endorse this package as it has come in today. Everybody has filed reservations of one kind or another. The silence is deafening in terms of support around the table on either side of the aisle.

I was struck by your comments on veterans' and military personnel pensions, because you were very forthright about it and you made it clear how you feel. You suggested that the Joint Chiefs of Staff ought to be called before the committees of the Congress to talk about this. Well, they do not work for the Congress. They work for the Commander in Chief, your boss, the President.

Does the President feel the way you feel?

Mr. STOCKMAN. I do not think so.

Senator RIEGLE. Is that why he has not called upon them to discuss the issue?

Mr. STOCKMAN. Well, look. The issue has been raised within the administration many times, and the judgment has been that it would not be—and there is an argument to be made that it, in the short run, could have some adverse impacts on recruiting and morale.

But I think that argument does not dissuade me, and I only stated a personal opinion that if you have to spend a half million or a million dollars over a lifetime to recruit somebody, you had better find a different way to recruit people to the forces. That is all.

Senator RIEGLE. My point is this, the person that you need to convince first is the President, because he is the Commander in Chief; he is the person to whom the Joint Chiefs refer to. And if, as you say, his opinion is different than yours, I think that is really where you have to start in terms of persuasion.

PRESIDENT HAS KEPT PROMISE ON SOCIAL SECURITY

But let me ask you this—why was Social Security left off the list? I support the fact that it was left off the list. I have followed the President's comments on this issue carefully over a period of time. For the record I would like an explanation as to why Social Security was put aside and why no cuts have been proposed there.

Mr. STOCKMAN. Well, it is probably due to a novel reason, in terms of the thinking of many around here. But the President pledged he would not touch it. So he kept his promise.

Senator Riegle Does that include the COLA's as well?

Mr. STOCKMAN. Yes.

Senator RIEGLE. I appreciate again the forthrightness of your answer. I take it that he is not going to backtrack on that at all?

Mr. STOCKMAN. He has no intention.

Senator RIEGLE. Well, he may not have an intention, but are you saying there could be circumstances under which he might?

Mr STOCKMAN. Well, Senator, people have been dancing around this one for 2½ months, now. I think it is fairly clear what the whole history of 4 years has been on this; who took it off the table first, who threatened demagogic attacks first, why we got into an impasse where we cannot rationally talk about $200 billion worth of spending—more spending than the GNP of about 120 of the 150 countries in the world. But somehow, forces have conspired to make it so. And so now, if we are just going to spar with words here, we will not accomplish anything.

SOCIAL SECURITY NOT ADDING TO DEFICIT

Senator RIEGLE. No, I am not interested in that, either. Now, the President said in his last press conference that Social Security is not causing the deficit, that the Social Security fund is in surplus and is not adding to the deficit.

Is that correct?

Mr. STOCKMAN. Well, yes, that is absolutely correct, and Medicare, then, is causing the deficit, because $20 billion a year is unfunded for part B, and because the payroll taxes for HI and part A over time were inadequate. So one of them is in surplus, one of them is in deficit, and they are part of a family of programs that are designed to help the elderly, based on benefits they earn. So we will just keep the whole analysis.

Senator RIEGLE. Is the Social Security trust fund now going up or down? Is it holding its own?

Mr. STOCKMAN. Well, it is going up a little bit, but remember that payroll tax has an HI earmark and an OASI earmark and a DI earmark. And as far as the worker is concerned, the only thing he looks at is how much they take out, and over time, we keep fiddling with the DI share, the OASI share, and the HI share. So it is more sensible, from my point of view as a budget analyst, to look at the basic programs funded out of the payroll tax and see where it is budget help or harmwise.

Senator **Riegle**. If we were to cut Social Security, which I would oppose, would that reduce the deficit? The President has said it would not, he stated that it did not cause the deficit, and if Social Security were out it would not reduce the deficit.

Is that correct?

Mr. **Stockman**. Well, what he is saying is that the deficit in the general fund would not be cut, and you would simply borrow an increased surplus from the Social Security fund to cover it. So the true deficit would not be cut. The reported deficit for a period of time would, but sooner or later, we are going to have to pay back the fund.

Senator **Riegle**. So, if we were to do as some have suggested, and that is, cut Social Security benefits so that the surplus went up, the Government would actually borrow that money to do other things with it.

Mr. **Stockman**. That is the scheme that we use, but on the other hand, we may be in the situation one of these days—well, we are right now—where we are borrowing $20 billion to pay for part B. That is the general fund contribution.

ENTIRE SOCIAL SECURITY PACKAGE NOT IN SURPLUS

Senator **Riegle**. Well, that is part of it, but there is still a surplus over and above that.

Mr. **Stockman**. No, there is not. No, that is not right.

Senator **Riegle**. I thought I heard you say there was.

Mr. **Stockman**. No, no, no. If you take——

Senator **Riegle**. So, Social Security today in total is not rising.

Mr. **Stockman**. If you take Social Security plus Medicare, all of it, part A and part B, and look at all the taxes that come in, all the spending that goes out—which, this year, will be about $270 billion—it is not in surplus. But the President has addressed only the old age part, OASDI, not the entire——

Senator **Riegle**. Let us just take that part. If the Social Security surplus then was increased, or there were extra dollars, the Government then normally borrows that money for other purposes, does it not?

Mr. **Stockman**. Well, theoretically, it is all bookkeeping, Senator, as you know——

Senator **Riegle**. I know, but where does the money go?

Mr. **Stockman**. Well, I would say right now it is borrowed from OAS/DI, Social Security, and loaned to Medicare part B to pay for the physicians' costs of the retirees.

Senator **Riegle**. If the benefits were cut further so there was more money, and that money was shifted into the Federal Government, would it not, then, be used for the range of additional Govenment spending.

PAYROLL TAX COULD BE REALLOCATED

Mr. **Stockman**. Well, you could do that. But another thing you could do is reallocate the payroll tax away from the Social Security Trust Fund and toward HI, or even start funding part B with those revenues that are coming in. That would put any savings where they belong, to help the elderly keep all of their programs solvent. You could do that, and I merely offer that as an observation.

Senator RIEGLE. Well, I will just finish by saying that I am going to help the President keep his promise on Social Security. I think he was straight forward about it. You have repeated it here today. I think the country took that into account when it voted. I feel that the promise needs to be kept, and I am going to do everything I can to help you see that it is kept, consistent with the request you have made today.

Thank you.

Chairman DOMENICI. Senator Exon is next, but allow me to just ask a question here. We have an option to finish with Senator Exon and recess for caucuses and come back, and Mr. Stockman appears to be willing. But I think we ought to just stay and finish up the questions.

Senator Riegle, did you want another round?

Senator RIEGLE. Well, not before everybody else has had a chance, Mr. Chairman.

Chairman DOMENICI. I understand. We have no one else who is seeking to ask questions. I think what we will do is go on to Senator Exon, and if we have any remaining questions, we will stay and finish them, rather than recess, and we can go late to our caucuses.

Senator Exon—Senator, before you ask your questions, could I ask you if you could—I saw a little excerpt last night on one of the television stations that covered your hearing yesterday in armed services where you were inquiring of the Secretary of Defense. I will paraphrase, but you were talking about the fact that what the President asked for in the last 2 years, or 3, at least, we have reduced, and you predicted a number that you thought it would come out at, and I think you asked the Secretary, "Could you tell us what you would reduce in order to get that percent?" And I think the percent was 3, but that is not what I am going to get to.

DOD SAYS DEFENSE SPENDING GOOD FOR NATIONAL ECONOMY

Did I hear the answer correctly, that the Secretary said, "That would be very difficult. We have already cut all we can. But we could get rid of a couple of divisions"?

Senator EXON. Yes. The answer is yes.

Chairman DOMENICI. And didn't he also say, "Of course, we do not want to do that, we do not think we should; that would also cause unemployment"? Wasn't that part of the answer?

Senator EXON. That is correct He also maintains that defense spending is really good for the national economy, because it brings in a lot of tax money.

Chairman DOMENICI. I thank the Senator.

The Senator may proceed.

Senator EXON. I would just like to ask my colleague from Michigan whether he is also interested in helping the President keep another campaign commitment that he made previous to this one, and that is, balancing the budget by 1984. Are you interested in helping the President with that campaign commitment?

Senator RIEGLE. That kind of slipped away, didn't it, Jim?

Senator **Exon**. It slipped away, and therefore, every time the President makes a campaign commitment, it is not always kept. I think the record very clearly shows that.

Mr. Stockman, you brought up the matter of Social Security, and I do not know about others, but you tried to blame the Democrats for it, and I do not think it is a Democrat or a Republican problem; it is a national problem. You indicated that only the Democrats bring it up in campaign, and I want to assure you, since you brought it up, that it was part of the campaign of the U. S. Senator from Nebraska last year. In fact, to the extent that my opponent's campaign, which was run lock, stock, and barrel out of Washington, DC, I suspect by some of the people gathered in this room here today, they hit me over the head with a statement that the chairman of this committee, my distinguished friend from New Mexico, made on the floor, that I was supporting last year an overall freeze, including COLA's. They got their figures all mixed up, and even went so far—"they" being the Republicans in this instance—to have a reporter call a member of the Majority staff to help straighten it out. So it does, you see, get into the area of politics on both sides. But we were able to handle it.

DEFICIT PROJECTION HAS INCREASED

Now, let me get down to some of these figures so that maybe I can understand them. Last August, which was not very long ago, the deficit projection, I believe, that you made, or your Department made, for 1985 was $167 billion in round figures. Is that about accurate, in your recollection?

Mr. **Stockman**. In the midsession review last August?

Senator **Exon**. Yes.

Mr. **Stockman**. Well, that was the policy estimate that included action by Congress on a lot of things that did not occur. And it also did not include the off-budget spending, which we have now consolidated into the total budget.

So, if you make adjustments for that, the equivalent of $167 billion last summer would be about $195 billion now.

Senator **Exon**. But in any event, after the election, that figure—which I assume you are now explaining—included off-budget items, which the $167 billion did not—rose to about $205 billion, or a $38 billion increase.

Mr. **Stockman**. Yes.

Senator **Exon**. Likewise, the figure that we are looking at now for the budget for 1985 has increased further, as I understand it, to $222 billion. You know, there is a big difference between $167 billion last August and $222 billion today.

Now, I accept your word on that, because I think you have always been forthcoming on these kinds of things. A major portion of that is off-budget items?

Mr. **Stockman**. Well, let us just go through it, if we can, and solve it very quickly.

Roughly, $13 billion of it, is off-budget, so if you add that back in, it is $180 billion last August with off-budget included; now, $222 billion.

Then, there was about 10 billion dollars' worth of revenue improvements in there—mainly putting a limit on the tax exclusion of health benefits, which Senator Riegle and others are totally opposed to around here, and it did not get done.

So if you take the policy items that we had pending that were rejected by Congress out—I cannot remember the precise number, but let us round to $10 billion—so that is $190 billion.

Now, as part of our deficit reduction action last summer, we passed the tax bill, which tightened up a lot of different loopholes. One of those made all of the tax-exempt housing securities that are now floating around no longer tax-exempt or at least, threatened that way by an IRS interpretation. We did not know about that until September, so since then, we have had to buy $13 billion of those public housing tax-exempt securities, which we owe on directly from the local public housing authorities that had issued them. So if you add that in, you are up to $203 billion.

So, without any kind of change at all except off-budget, the public housing notes and the policy that was not done, you are at $203 billion versus $223 billion.

What accounts for the $20 billion remaining difference? Well, the economy came in a lot slower in the fourth quarter, inflation came in a lot lower than we expected, and that reduced the receipts somewhere in the range of $18 billion.

So that pretty much explains it.

RISE IN ESTIMATE VERY SMALL FRACTIONAL ERROR

Senator EXON. When did you figure out that this $167 billion estimate that we went into the election on was going to rise dramatically for whatever reasons?

Mr Stockman. Well, it did not. Senator——

Senator EXON. During the election, the general thought was that it was only $167 billion.

Mr. STOCKMAN. Well, Senator——

Senator EXON. Did that not come to your attention until after November 6?

Mr. STOCKMAN. Well, Senator, it did not rise dramatically. Let me just go back to it. The $13 billion on off-budget is an accounting thing. I have been saying for years, let us count everything we spend. Various committees up here put farm programs off-budget so we wouldn't know how much we were spending. So we got all of those back on-budget. It did not rise. And last summer, the on- and off-budget deficit we were projecting was $180 billion, so that one did not go up. The public housing note thing was a freak accident, but over the long run, we owed them money, and that $13 billion came in one afternoon when the IRS ruled that we could no longer finance that debt on a tax-exempt basis. So it did not rise. The accounting changed, although long run spending did not.

Then finally, we thought there was a good reason for some of these deficit reductions we had in the budget still this summer, but Congress did not act on them. So none of that was a surprise. That is just accounting changes or policies that were not done. The only real change is $20 billion. And that, I think it is fair to say you did not know in August that the economy was going to practically freeze in its tracks or that inflation that we were assuming would be 5.8 or 4.8 or 4.9, would come in at 3.7—but I can tell you, when you do the work on it, and your staff on both sides of the aisle here will agree, that makes a $20 billion difference in revenue out of an $800 billion base. That is a 1 or 2 percent, or a very small fractional error. And that is what happened.

So I do not think we ought to say that anybody deliberately misled anybody with numbers. CBO showed the same thing, by the way, for 1985 with the President's budget proposals back then.

Senator **Exon**. My time is up, Mr. Chairman. I will have another question or two in the short second round.

Chairman **Domenici**. Senator Quayle?

THE 2-YEAR BUDGET SHOULD BE BINDING ON HOUSE AND SENATE

Senator **Quayle**. Thank you, Mr. Chairman.

I want to go back to the issue of defense. Our chairman and ranking member both talked about exploring the possibility of a multiyear arrangement with defense. I personally am intrigued by that possibility. I have been a strong advocate, and continue to be a strong advocate now for a 2-year budget. The Pentagon has sent up 4- and 5-year projections of spending, so there are figures on which to base a multiyear budget. I think if we should get some sort of agreement, on what we are going to do for 2 years—I do not know how we get to 3 years and make it binding, on future Congresses. What now happens usually is that after we go through all the gyrations of a freeze versus 5.7 percent growth—let us say you come up with a package where you want 3 percent growth in authority as well. And the chairman knows full well, and so do you, Mr. Stockman, that authority is very key and very important to defense, unlike some of the other programs. You get an agreement for 1 year, but the agreement has ramifications for the future. And Congress comes back in the future and changes its plans. We need multiyear planning. But I think that the caveat here is that it has got to be 2 years, and it has got to be binding both on the House and the Senate, so a year from now, when we call you back in, and you go back to that agreed number of, say, 3 percent real growth for 2 years, No one says, "That is too much." That is the down side, and that is the risk.

But I think that as far as program stability and improving where we are going to go on our military procurement and other matters, that it makes eminent sense. I certainly would be willing to join in that effort with the understanding that this agreement is going to have to be binding on both the House and Senate for 2 years—not just the 1-year binding, where we come back in and negotiate next year after we have already ratcheted down to 3 percent real growth.

DIFFERENTIAL LESS THAN 3 PERCENT

Second, Mr. Stockman, I think that this time the budget is a little bit different than in the past. I might just say that with all the hoopla and all the rhetoric that we have heard it all before. When the Congress finally gets around to responding to the Reagan budget, there has been a less than 3 percent differential over the last 4 years. I just calculated the difference, and it is less than 3 percent. So, by the time we get through all these "dead on arrival" speeches, Congress, if history is right, will make a 3-percent adjustment—maybe less. In 1981, it was less than 1 percent.

But the one thing that strikes me as different this time is that you are saying in the nondefense area—and you really never said this before, except for some modest degree in the reconciliation of 1981—that there are certain substantial programs that are going to have to be eliminated.

You have put out a chart and are saying in the nondefense that there are certain programs—revenue sharing, UDAG, Amtrak, and others—you are saying to Congress and the Nation, that there is no way that we can get down to, say, 21 percent of GNP without significant program elimination, not restraint of growth, but program elimination.

TOTAL PROGRAMS MUST BE ELIMINATED

My question to you is how serious are you about this? Is this just part of a negotiation that is going to go on in response to the chairman's first question, or is the administration dead-set that if these programs are sent to the President or reauthorized, that they are going to exercise something that they have not done in the last 4 years, and that is the veto of these authorization and appropriation bills that go above the budget. I think that that club, the veto, it has been nonexistent. I do not know what major bill you vetoed last year—you can probably fill me in, but I think it has been nonexistent.

Is this going to change?

Mr. STOCKMAN. Well, Senator, let me respond by saying first, on your point, we are completely serious about it, and I think if you analyze it—and I know the chairman agrees—unless we eliminate total programs, have some wholebody surgery, we are not going to be able to get the budget down. And that means you are going to have to make some choices. And all this business about restraint, or reducing the rate of growth, and so forth, is appropriate for some areas of the budget, but some things have to go.

Now, second, unfortunately, Congress has so many mechanisms to beat us, that even if we vetoed the Job Corps authorization—which is something I know you have been interested in—it will probably end up in the Labor/HHS appropriation bill. And then, how do we veto a $33 billion Labor/HHS appropriation bill, because the only thing in it that we disagree with is the $600 million for Job Corps. Therefore, if we rely on the machinery as usual, and even though we veto every one of these authorizations, you will not actually eliminate the program and stop the spending. It will be put in on a continuing resolution basis. We have not had an authorization for EDA, I think, or Appalachia for years——.

Senator QUAYLE. Legal Services is another one.

Mr. STOCKMAN [continuing]. Legal Services. What we need is a positive action by Congress upfront, in a reconciliation bill, to excise that program from permanent law, period, and make it subject to a point of order if anybody tries to fund it in an appropriations bill.

Now, that is the choice that you will have to make. And if you will put that in the reconciliation bill, it will never be funded, and we will be able to implement the policy. But if you do not give us that, your legislative procedures up here will beat us every time—even though we would veto it if we got a shot at it.

ELIMINATION OF PROGRAMS IS ONE-SHOT DEAL

Senator QUAYLE. So you basically are saying that we have a one-shot deal as far as program elimination is concerned.

Mr. STOCKMAN. That is right.

Senator QUAYLE. And that is through budget reconciliation because beyond that—and that was my next question——.

Mr. STOCKMAN. You cannot get your hands on it.

Senator QUAYLE. In this continuing resolution, that is what always happens. It goes into the continuing resolution, you add everything there, and those objectives are not accomplished.

OK. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you, Senator.

Senator Riegle?

Senator RIEGLE. Thank you, Mr. Chairman.

I want to get into two specific program cuts that you are recommending, and I want to look at it from the Michigan point of view, which is both of our home State.

ELIMINATION OF UDAG WOULD HURT MICHIGAN

UDAG, as you know, has been, I think, one of the most effective programs nationally. I do not know whether you would agree, but I am stating my own view now, in terms of stimulating certain kinds of investments that would otherwise not take place. To my view, it is sort of a variation of enterprise zones, because it leverages private investments and so forth, as you well know.

In Michigan, since the program started, we have had over 2 billion dollars' worth of new investments. These investments driven by UDAG projects, in roughly 50 cities across the State, have added several tens of thousands of jobs. Despite that, we are in our 60th consecutive month in the State with unemployment above 10 percent. We are in a situation where help was really vital on the margin. If this program were to be taken away at this point, States like Michigan, that are struggling to get a new economic foundation in place, which we are doing, but painfully, and regions like the upper Midwest may be the most damaged by that.

I am just wondering what is the justification, really, is for doing away with a program that I think has been very successful. I think it is a very successful program which comes off a free enterprise philosophy. I do not understand why you oppose it and are proposing to do away with it.

Mr. STOCKMAN. Senator, let me try to respond with a tale of two struggling States and two struggling cities and why we think UDAG ought to go.

New Jersey is a struggling State that has problems like Michigan. The New York metropolitan area is a struggling city that has problems like Detroit. The two delegations are now waging a holy war as to whether or not UDAG grants are stealing investments and jobs from one area, 30 miles away, toward another. That tips off the basic problem with the program, and that is, it does not create new investment; it just helps to relocate it in the competitive struggle to subsidize investment that is waged by localities in various parts of the country and even next door to each other.

We have put out regulations saying that you cannot use UDAG money to pirate away jobs and investment from neighboring towns or neighboring counties or areas. They are being noisily denounced by New Jersey, and I think, or maybe the other way around, welcomed by New York.

But the point is that UDAG is designed to help areas compete away jobs from somewhere else——

Senator RIEGLE. That is the way the private system works.

UDAG PIRATES AWAY JOBS FROM OTHER AREAS

Mr. STOCKMAN [continuing]. Now, wait a minute, Senator—but now, we have put out regs saying that you cannot do what the program is designed to do—pirate away jobs from somewhere else.

Now, if you have a program that does one thing, and it is regulations that prohibit it, you have got a rather illogical contradiction to deal with.

The second case, Michigan, the western part of your State. I got onto UDAG and why it is not a good program but a terrible program when I was in Congress. The motel owners from Saint Joseph which is a city, as you know, on one side of the river, with Benton Harbor on the other, came in and said they were going to build a huge, brandnew hotel in Benton Harbor with a UDAG grant, and it was going to siphon away all the business from the motels and hotels in Saint Joe that had been built with private capital. They thought this was terribly unfair because the region could not provide a large enough demand base for both, and so——

Senator RIEGLE. Yes, but that is a unique case, I must say——

Mr. STOCKMAN. No, it is not unique; it happens all the time, Senator. It happens all the time.

Senator RIEGLE. Yes, it is a unique case. When you can cite that case, in the State of Michigan I can give you at least 100 examples, all kinds of communities, where the communities, regardless of the—I am talking about the broad political support in the communities, both parties, business, and so forth think it has been a stunning success, absolutely a stunning success.

Mr. STOCKMAN. It is, Senator, from a local point of view. But let us face it—every time word gets out that Marriott wants to build another hotel, a half dozen cities go into competition to get it, and they all try to get UDAG funds to be competitive. And the city that wins may feel better off, but the other five do not, and the fact is, Marriott walks away with the money.

Now, what kind of program is that?

Senator RIEGLE. I do not think it is fair, frankly, to take one illustration like that, or one company, and use them to try to discredit a program that has been enormously successful across the country and particularly in our home State. And if your recommendation is adopted, and if it is killed, it will do a lot of damage, and I hope to prevent it.

OMB SUPPORTS ELIMINATION OF REVENUE SHARING

On revenue sharing, I remember revenue sharing coming up in the beginning, because I happened to have been a Republican at that time. It was a Republican initiative, and it came out of the House, and I think it has been very effective over the years across the country.

As I talk with local officials from Michigan, they tell me that they do not know what they would do, today, without revenue sharing, that it is critical for them. I am hearing that from other colleagues from other States.

Do you also support in a genuine way the elimination of revenue sharing?

Mr. STOCKMAN. Absolutely. In the early 1970's, when we had a fiscal surplus and it was getting bigger as the defense spending from Vietnam ran down, it was probably a good idea. It is a very efficient way of providing a fiscal transfer to local governments. It does not take any bureaucrats, no Federal dictation. Local areas have used it as they see fit.

But that era is over. We are now in a budget era where we are $200 billion-plus in the hole, and we simply cannot afford——

Senator RIEGLE. Have you looked at where the money is going?

Mr. STOCKMAN. Sure. There is no——

Senator RIEGLE. This is what I am asking. Is there a study that has been done—an indepth study by OMB—that would show nationwide, not just a few illustrations, where revenue sharing has gone, is going? If you have such a study I would really like to have it for the record and for the committee, so we can look at it and see what the analysis does show.

Mr. STOCKMAN. Well, I think the answer is, Senator, I know what your position is—Flint cannot live without it——

Senator RIEGLE. Well, not just Flint.

Mr. STOCKMAN. Well, I know, but it is the older, depressed industrial areas that have lost their tax base——

Senator RIEGLE. I will give you another example. Bill Lucas, chairman of Wayne County, is here today, meeting with the delegation. He does not feel he can do without it.

Mr. STOCKMAN. Well, I know. But Wayne County is part of that. But the point is, revenue sharing is so diluted, and the allocation formula is so general that 39,000 units of government get it. Now, there is a small tax effort factor in it, and so forth, but basically, it is going to everybody, whether they need it or not, whether they can raise money to fund their fire department or their community college, from their own local taxpayers. And you cannot spend $5 billion a year trying to help Flint when you are helping Montgomery County and everybody else.

Senator RIEGLE. I am not asking you to just help Flint. I am not asking that.

Mr. STOCKMAN. Well, you cannot afford it. I mean, how can you talk about revenue sharing when you are $250 billion short of revenue?

ELIMINATE REVENUE SHARING NOT MENTIONED BEFORE ELECTION

Senator **Riegle**. You have supported it for 4 years here, and the President has signed into law bills that have supported it. You did not say one word before the election about doing away with revenue sharing—not a peep, not you or the President. It would have been fair and, more honest to do so if that was really in everybody's mind. The people at least would have known what the consequences might be. But none of that was done. We had no problem before the election.

As Senator Exon points out, in fact, the numbers suddenly changed dramatically afterwards. If you are going to come along now and propose not just freezing these programs or cutting them back on some level, but absolute elimination—it was here yesterday and we were for it, today it is gone—I think you have got to have a deeper justification of that.

I want to see an analysis of what it is going to do to the country—all the 50 States. I am as interested in the other 49 States as I am in our State. The fact that it might be your philosophic view, or somebody else's philosophic view now, after the election, does not cut any ice at all. I think we have got to see the analysis, and if you have not done it, do it. And if you have done it, then I would like to see it.

Mr. **Stockman**. All right.

Chairman **Domenici**. The Senator's time has expired.

Senator Exon.

Senator **Exon**. Thank you, Mr. Chairman.

Mr. Stockman, you have come down pretty hard on the American farmer, almost to the point that I think you have got something in your belly that convinces you that the family farmer is out there, looking for a handout or a dole.

Now, this new program that the administration has come up with to make the farmer competitive in the international marketplace assumes, I guess—or, I have never heard you or the Secretary of Agriculture articulate the fact—that there is no level playing field out there today in the international marketplace if you want to plunge the already economically devastated farmers into.

I suggest to you, and I wonder whether or not you agree, that the main reason that our farmers have not been able to maintain their international markets and make any money is, No. 1, that the dollar is overvalued by about 30 percent, which places them in a noncompetitive position, and they are hit with a double whammy, of course, that basically, many foreign nations, including the European Community and the Japanese, are subsidizing their food producers much higher than ours. In other words, we would place an individual wheat farmer in Nebraska in competition with the treasury of France that is subsidizing wheat there at about $5.25 a bushel, and you want to even reduce the $3.10 average subsidy that we are providing for American wheat producers.

VALUE OF THE DOLLAR NOT JUST PROBLEM OF FARMERS

Do you think that the value of the dollar and the foreign subsidies are the main reason for the fact that we are losing our international marketplace, which is hurting the farmers terribly?

Mr. **Stockman**. Well, it is obvious that the high dollar is a problem, but it is not just a problem for agriculture. It is a problem for export manufacturers, high technology. It is a problem for anybody that is left in the shoe industry, trying to compete with low-priced imports and so forth. It is so general a problem for our economy that we cannot use that as a basis to subsidize any particular sector, because if we did, we would have to spend $30 or $40 billion trying to make it up across-the-board.

Second, though, yes, there are international subsidies. France subsidizes wheat; I am aware of that. But the United States determines the world price of wheat with our price support. And the higher we make our price support for wheat, the less they have to subsidize to put their high-cost wheat into the world market. If we lower our price support as we are proposing by about 50 cents a bushel, it will cost them 50 cents more a bushel to dump into the world marketplace every bushel of wheat that they are producing inefficiently and at high cost today.

That would be more of a signal, that would be more of a shot across the bow to unfair foreign traders, than all this little "Mickey Mouse" stuff we have done with subsidizing exports for the last 4 years.

Senator **Exon**. I suggest that your view is very shortsighted, because if you are successful with what you are prescribing—that prescription for disaster—then I tell you that the American farmer is not going to be there to farm, because he cannot begin to compete with what is going on today.

I do not think that your formula that will force things to be equitable is going to work. The French are going to maintain their market because they have a policy to subsidize their farmers, right or wrong, far more than we do. And that message is not getting out and is seldom, if ever, mentioned by the administration. At least I am glad you recognize it today.

Thank you, Mr. Chairman.

Chairman **Domenici**. Thank you very much, Senator Exon.

Mr. Stockman, in terms of the details with reference to the domestic programmatic reforms, I assume that you have analysis of the administration's justification for each of the reforms; is that correct?

Mr. **Stockman**. That is correct, Mr. Chairman.

Chairman **Domenici**. And is that document available, and has it been made available to both sides?

Mr. **Stockman**. We have produced thousands of copies, and I think it has been made available on the Hill, but I will put this in the record if you want, in case it has not.

Chairman **Domenici**. I do not know if we ought to put it in the typewritten record, but I think we ought to make it a part of the committee's files so that it will be there.

ACROSS-THE-BOARD FREEZE WILL NOT DO

Chairman **Domenici**. I want to thank you for your appearance. I would just like to summarize. I hope that the members of this committee and the Senate at-large will understand a few basic principles that came out of this hearing.

How can we get a substantial deficit reduction plan, approaching $50 billion in outlay savings in the first year, and growing to where it has some reasonable chance of getting that third-year deficit, under good economics, down into the $100 billion range? I think you have clearly demonstrated, and the President's budget demonstrates, that a freeze in budget authority across the board for everything will just not do it. That leads to the conclusion that, whether we like it or not, we have to look at that long litany of domestic programs that are suggested for reform, termination, or substantial diminution.

My numbers would indicate that a freeze anywhere from $12 to $20 billion off the mark, depending upon what baseline you start with and what economic assumptions you use.

I want to compliment the committee because I believe, although we have had our share of discussion with you today—and while some Senators clearly have indicated that they are for reducing the budget, but not the programs that they clearly favor—that there has been a lot less discussion of individual interests than one might have expected here today. That is one of the weaknesses and at the same time, one of the strengths, of collective decisionmaking in the Congress. Everyone does not have to agree to everything. As a matter of fact, a number of members can vote against many of the things. If it turns out that the mix is right, we could end up with a very substantial budget.

MAJOR RECONCILIATION INSTRUCTION HOPED FOR

I do want to say publicly here that, as chairman of the committee, it is my hope that this year we will get a major reconciliation instruction—probably the most major that we have ever put together. I am hopeful that it can be as specific as we can possibly do it and be consistent with the rules and parliamentary processes that we abide by.

I know that is onerous. I know to some, it is distasteful, and I know to some, it will be assumed to be out of order or irregular. But I have come to the conclusion that the kind of reform that has to take place cannot take place without something extraordinary.

Mr. Stockman, you have explained, in response to Senator Quayle, that the President did not like Job Corps and clearly wanted to bite the bullet and say, "I will be glad to sign a bill." The point of it is that he is apt never to get a bill. If the President wants major reform in the Eximbank, the point is, that will not happen either, unless something is done in a comprehensive way.

We have now learned that even deauthorizing, failure to reauthorize seems to impede continued funding only if it meets with majority approval here, or conversely, if there is a majority that want to fund it anyway out of the Committee on Appropriations, it will be funded.

So I am hopeful that everybody understands that, while the job will be onerous, and while some will not like what we do, we have a very serious responsibility to try.

I want to say one other thing, and this is just from my own standpoint. You went through a 25-minute explanation of the Defense Department. It is defense, as you see it, against a notion of a

1-year freeze in budget authority. I want to say for myself that yours is the clearest explanation of where we spend our money and how we got where we are that I have heard.

We will have the Secretary of Defense up here in a few days, and I think it will be extremely helpful. For those who want to change the format of any of the major efforts of our Government, we do have some burden of showing how we will change the format. I do not apologize. It is very difficult for this committee, and it has been very difficult for this Congress on the issue of defense. And one might assume, as you have, that we have voted all these things in with eyes wide open. We knew or should have known the consequences of where we are now stuck in terms of level of funding. I am not now addressing need. I am merely talking about what we knew or did not know.

WE HAVE TO ADDRESS OURSELVES TO OUTLAYS

I am not embarrassed to say I do not believe I knew, and I don't believe very many members of this institution knew where we were going when we voted the way we did. There are a couple of reasons. Frankly, the appropriations process appropriates budget authority, not outlays. And there has been no requirement around here, and I am not suggesting that there should be, that anybody concern themselves with the level of outlays, even in the year of the budget authority, much less a requirement to clearly state what the expenditures are going to be the next year and the next year. There is almost an unwillingness to concern themselves with it. As a matter of fact, when some of us do concern ourselves with it, including you, sometimes, it is thought to be a rather useless exercise up here, and let us get on with the business as it has been.

I hope this committee concerns itself with the level of outlays. We did one year, and I think we ought to again. The President's proposal is an outlay freeze for both years—spend no more one year over the other. Eight hundred and four billion, I guess, is the number. It will soon dawn on everyone how difficult that is. That figure is not budget authority, it is outlays. We have to address ourselves as best possible to these outlays and estimate them.

I hope, as we proceed with our deliberations, that you will make yourself available with reference to the outlay estimating. We have CBO, and we have our staff. But I would hope that we can work together so that we do not have disparities based upon the same policies, as we have sometime in the past, based upon what goes on either in the bowels of the Defense Department or the OMB versus our institutions.

In the meantime, I assume you will make yourself available to the members of this committee with reference to the programmatic impacts of the changes recommended and the justifications behind them.

SPENDING CUTS ARE SPENDING CUTS

I want to make one last comment. I asked Senator Exon about the Secretary of Defense's comments. He will be here. I will have an opportunity to talk to him. But I have no empirical evidence, and I wonder if you do, that cutting $1 billion in a general kind of way out of defense—just cut $1 billion, reduce spending $1 billion—that it has any more significant economic, unemployment, or tax consequences than cutting $1 billion in mass transit subsidies or revenue sharing. As a matter of fact, I am certain on revenue sharing that there may be more impact, since they are using it for capital improvements and not ongoing budgetary items. But all of them will yield some residual unemployment and some color of economic displacement at some location, and someplace in this economy.

We are adding 300,000 jobs a month, and hopefully, we can assimilate it in a macrosense. But I do not believe it is fair to state that a cut here is less significant in terms of those consequences than a reduction or cut in defense. I know of no empirical evidence to back that statement, and I just wonder if you do.

Mr. STOCKMAN. Well, Mr. Chairman, I agree with you. A dollar of spending cut is a dollar of spending cut, and it circulates through the economy in the same ways.

Thank you.

Chairman DOMENICI. Thank you very much.

The committee stands in recess.

[Whereupon, at 1:15 p.m., the committee was adjourned, to reconvene Wednesday, February 6, 1985, at 10:00 a.m.].

Written Questions From Chairman Domenici to Mr. Stockman and the Responses

PUBLIC HOUSING LOANS

The 1984 tax bill has called into question the tax status of obligations used to finance public housing projects and kept local housing authorities from issuing tax-exempt project notes. As a result, the Department of Housing and Urban Development has been forced to make direct loans that will total about $17 billion by the end of FY 1986. The President's budget proposes forgiving these loans to end what has become an extremely complicated financing process.

Question

1. What is the reason for this proposal?

Answer

1. The chief reason for proposing to forgive the loans is to clean the Government's books of these complex loan and debt-service arrangements and to put in their place a simple, direct method of financing public housing projects.

The three-way forgiveness plan proposed by the Administration would clear the way for the proposed new financing method. Under the financing used prior to the Deficit Reduction Act of 1984 (DEFRA), the Federal commitment to provide debt service payments for tax-exempt notes of local housing authorities constituted a full Federal guarantee of the outstanding principal. With the suspension of tax-exempt financing imposed by DEFRA, the contingent liability became an actual liability. HUD is now borrowing from Treasury to make loans to the local authorities to repurchase their outstanding tax-exempt issues for activities committed through the end of 1985. As part of the overall financing reform, the obligations of local authorities to repay HUD, HUD's obligation to repay Treasury, and Federal obligations to pay the debt service under annual contributions contracts would be cancelled. In this way, HUD has satisfied its requirement to cover the construction costs, yet it will not have to continue administering the complex financing that previously existed. In order to improve the method of future financing for these projects, the Administration proposes a shift to direct Federal funding starting in 1986.

Question

2. What are the advantages of the administration's proposal, compared with a return to the old system of tax-exempt borrowing by local authorities?

Answer

2. The advantages of the Administration's proposal compared to the old method of tax-exempt financing are:

A. Public-housing financing will be more efficient, straightforward, and greatly simplified.

B. The proposal has no effect on Federal liabilities, because the Government, via its debt servicing responsibilities, has already incurred the debts it is paying off. The only difference is in the timing of the payments. While higher outlays will occur in 1985-1987, outlays will be lower from 1988 on.

C. The proposal has no effect on existing public housing program commitments or projects.

D. It eliminates $14 billion in tax-exempt obligations that provide tax expenditures benefiting high tax-bracket individuals and corporations.

E. It eliminates unnecessary and costly intermediaries and transactions that resulted from HUD's separate tax-exempt financing operation. Treasury can better manage Federal financing needs if the separate financing operation is eliminated, and administrative costs for both the Federal Government and local authorities will be reduced.

VIEWS OF THE CONGRESSIONAL BUDGET OFFICE

WEDNESDAY, FEBRUARY 6, 1985

U.S. Senate,
Committee on the Budget,
Washington, DC.

The committee met, pursuant to notice, at 10:15 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Andrews, Symms, Kasten, Quayle, Gorton, Chiles, Hollings, Sasser, Metzenbaum, and Exon.

Staff present: Stephen Bell, staff director; and Gail Fosler, chief economist.

For the minority: Richard N. Brandon, staff director; and John Hilley, senior economist.

Chairman Domenici. The committee will come to order.

We have a number of conflicts today, Dr. Penner, but I assume that before we're finished here a number of Senators will have had an opportunity to ask you questions. If any Senators were unable to attend because of conflicts, and have written questions, we will get them to you as quickly as possible.

Since we don't have a very large opening attendance, why don't we just permit the Senators, if they desire, to make opening statements. I will try to make mine brief.

OPENING STATEMENT OF CHAIRMAN DOMENICI

As you know, Dr. Penner, we welcome you here today to discuss your annual report. Yesterday, we heard from Mr. Stockman on the administration's economic outlook and budget proposals. I hope that we can move forward in defining the economic picture that you see, and the budget numbers we will be working with this year.

Let me begin, Dr. Penner, by telling you where I think we are. The President has proposed a tough budget in terms of domestic restraint, no doubt about it. He proposes to reduce spending in the next fiscal year by $50.8 billion in outlays. Of that amount, he proposes that about $39 billion come out of nondefense programs —as I indicated, a very difficult agenda. I should add that means nondefense, excluding Social Security. This year's budget is as tough on nondefense spending as any we have had, and may even be tougher than any this President has ever sent up here. I do not agree with his approach entirely—I tell you that up front—but I do agree with his goal. I believe that we have to take a hard look at the spending side of the budget ledger and decide what we can afford, and what we cannot. I do support the notion that we should have a substantial spending reduction bill, probably in the form of a major reconciliation instruction from this committee. It should be honest and forthright, and clearly credible and implementable. The first year's savings should approach $50 billion, as the President in his budget, concludes, we need.

BUDGET AUTHORITY FREEZE NOT ENOUGH

Most of my colleagues know that I think such a budget should have major freeze notions in it. My colleagues who were here yesterday know that, and I am quite sure that a freeze on budget authority is not enough. In order to save $50 billion, using the OMB numbers even with a freeze in defense, and across the board in all other domestic programs including Social Security, we would still need another $12 billion of the President's domestic cuts. Depending upon who is doing the estimating, we might need more than $12 billion more to reach that $50 billion goal.

If we use CBO's estimates, we might very well need $25 billion in additional cuts beyond the freeze, to reach the $50 billion goal. Every major category of spending has to be looked at, and many of them are going to have to be part of the solution. What's more, to put together a bill that will pass means that we are going to have to restrain defense spending over 3 years, substantially more than the President proposes. We need to do this in order to get the support for the domestic cuts.

DEFENSE SPENDING SOMEWHAT ON AUTOMATIC PILOT

This leads to the issue of defense. Yesterday, Mr. Stockman made a rather persuasive case that defense spending is somewhat on automatic pilot. He did not quite say that but that is what I concluded from his statement. Indeed, I think, defense is on automatic pilot, set knowingly, at least Mr. Stockman assumes, by this Congress. While I am not an expert in defense, I looked at the issue in some detail, and I believe that there may be a somewhat larger buffer in defense than the advocates of higher defense spending would have us believe.

In fact yesterday, Mr. Stockman showed us how we could cut defense by $20 billion without cutting anything when it came to defense programs. Most of it came from lower fuel prices, reestimates of inflation and the like. I hope that you will provide this committee with your interpretation of how we can affect the defense budget in a real way, with a clear explanation of what the tradeoffs are, or might be.

BUDGET ESTIMATES

And finally, Dr. Penner, I would like to raise the issue of budget estimates. I note that CBO estimates of the current services baseline budget are very close to those in the President's budget. CBO baseline deficits estimates are actually $10 to $15 billion lower than OMB's in fiscal year 1986 and fiscal year 1987. In fiscal year 1988, both CBO and OMB estimate the deficit at about $248–$249 billion. Although it is hard to accept the fact that the budget deficit is so high, after all the efforts this committee and the Congress have made to bring it down, I am pleased that we seem to be starting with some benchmarks that are relatively close.

Dr. Penner, I understand that there are some significant differences between the CBO and OMB baselines for defense. As I understand it, both OMB and CBO have adjusted their defense baselines for the fiscal year 1985 appropriations. However, OMB has taken last year's Rose Garden level for its baseline. This is just a budget authority figure, and no policy was part of that settlement. CBO's defense baseline is last year's congressional budget resolution in terms of budget authority. I think I am correct on that.

However, you have reestimated the budget resolution outlays downward. This means that not only do we have a conceptual difference between CBO and OMB as to what the right starting point is—we also have technical differences in this function about the levels of outlays that will occur in fiscal year 1986 under what we are both calling current policy. I raise this issue because I think it is important that we not let technical differences get in the way. CBO has had great differences with every administration I can remember about the starting point on defense. In fact most budgets actually differed more from the CBO on an economic basis than the President's current budget, but on defense there are always differences, and this time they are rather dramatic on the outlay side.

As I understand it, the major economic difference between you and the administration arises in 1989 and 1990. Please correct me if anything I am saying in these opening remarks is not so.

DIFFERENCES DUE TO DIFFERENT ASSUMPTIONS

Most of the estimating differences are due to different interest rate assumptions. I am sure you will agree that no one knows what the rates will be. On the other hand, we clearly ought to know, as an institution, what we think is reasonable and believable, and act accordingly.

It is my view that we have to concentrate on making the right policy choices then the economy may very well take care of itself.

I hope that you can make an effort this morning to explain the technical differences which may detract from what we are trying to do. If we do not get that cleared up today, we may submit further questions, and you may have to help our staff from time to time, to make sure they are clear on the numbers before we start markup 3 or 4 weeks from now. Thank you very much.

I yield to the Senator from Florida. Senator Chiles.

OPENING STATEMENT OF SENATOR CHILES

Senator CHILES. Good morning, Dr. Penner. We are pleased to have you join us this morning to go over some of these budget options.

Throughout my service on the committee, it has been our practice to use the Congressional Budget Office figures to find our position on the economic map. You give us the certified version, and we try to go on from there.

If we have to go through the pain of cutting the deficit, and I think all of us do, then I think we had better do the job right, and we had better make sure we really cut the deficit, and make sure everybody is included in a fair and reasonable way.

So we want you to tell us whether it is really important to get the deficit down to two percent of the GNP. Is that not what we need to stabilize the debt, and keep interest from eating up the rest of the budget? We hope you will help us this morning by providing the objective figures we need.

None of us are happy that the deficit stays so high in the years ahead, and many of us are just plain worried that even those big deficits projected by the White House are actually a lot higher than they look. We just cannot play that game of floating numbers, and expect to really figure out what is needed to cut the deficit. We need dependable numbers, and we hope you will provide those for us this morning.

We also hope you will be able to give us a better idea of just how accurate the President's economic assumptions really are.

If you tell us we can get to the 7-percent home mortgage rates he is predicting, I hope you will also tell me where I can get one of those seven percent mortgages. We need some realistic estimates about what the growth rate will really look like, and what we can expect in the performance of interest rates, inflation, and unemployment.

"WHOLE BODY SURGERY" NECESSARY TO GET DEFICITS DOWN

David Stockman told us yesterday quote, "whole body surgery" was necessary to get these deficits down. If that is the case, we had better make sure the whole budget is on the operating table, and we look forward to a second opinion from you, Dr. Penner.

It seems to me most economists agree, we will not be able to grow our way out of this deficit hole, and it will be impossible to cut our way out by focusing only on the domestic programs.

We would like to know your views on that, together with your thoughts on revenue. We have got a long way to go before we bring the deficits down, but before we get moving, we have to know precisely where we are, and we hope you will give us that information.

Many people have been thinking up here, that there is an easy way to deal with the budget. As Chairman Domenici said, we just reject the President's cuts in the domestic programs, and instead, extend the freeze to Social Security and defense.

My understanding is that an across-the-board 1-year freeze will still leave deficits in the range of a $170 to a $180 billion for the next 5 years.

That is a lot better than $300 billion but it is still around 3½ percent of the GNP. So I hope that you will comment this morning about whether you think getting the deficits down to a $170 billion dollars will do the job for us, or not.

Chairman DOMENICI. Thank you very much, Senator Chiles. Senator Gorton.

OPENING STATEMENT OF SENATOR GORTON

Senator **Gorton**. Thank you, Mr. Chairman. Both the chairman. Both the chairman and the ranking minority member have spoken to a number of my concerns. Essentially, Dr Penner, you are our resource. You are our best source of objective information about the scope and the nature of the problem, you know, which we face, and your views, your facts and figures, are going to be vital to us in our determination. Essentially, it seems to me, even at this early stage in the budget process, we have three, perhaps four alternative courses of action which have been presented.

ALTERNATIVE COURSES OF ACTION

One is that of the President, which places the burden of lowering budget deficits on domestic programs other than Social Security. The second is the so-called across-the-board freeze which has the virtue and simplicity, and, to a certain extent, the dodging of responsibilities of treating all programs in at least a superficially equal fashion, but as the Senator from Florida said, falls short of meeting what most of us agree are minimum goals.

The third is, or are, a variety of freeze plus formulas, which would start from the across-the-board freeze, and then accept some, but not all of the President's proposals for cuts in specific programs.

And the fourth, from a dear colleage we have recently received, from Senators Andrews and Hollings, calls for rather substantial tax increases, a course of action which seems to me to be difficult to justify, and the base of a very real and very plain message which we received in the course of the election campaign.

In any event, like the Senator from Florida, and the distinguished chairman of the committee, I have been on the committee long enough, even in 4 years, to understand there there is no $50 billion line in the budget entitled "Waste, Fraud and Abuse", which we can repeal, and relatively easily reach our goals.

We are faced with difficult choices in the course of the next few weeks, and I hope that, while you cannot make those choices any less difficult, you can help make them more clear.

Chairman **Domenici**. Thank you very much. Senator Metzenbaum.

Senator **Metzenbaum**. I waive an opening statement.

Chairman **Domenici**. Senator Kasten.

Senator **Kasten**. Mr. Chairman, I have a brief statement, with some questions, that I would like to put in the record in the interest of time.

Chairman **Domenici**. Do you want to wait, then, Senator?

Senator **Kasten**. No; I will just submit these questions and a statement for the record, please.[1]

Chairman **Domenici**. Thank you very much. They will be made a part of the record.

[The prepared statement of Senator Kasten follows:]

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[1] See questions beginning on p. 147.

PREPARED STATEMENT OF SENATOR KASTEN

Mr. Chairman, as we begin another budget cycle, we are once again faced with large deficits and the problem of getting them under control.

I am pleased that Dr. Rudy Penner of the Congressional Budget Office is here. This year, we are committed to reducing spending to control the deficits, and I hope that Dr. Penner will have some workable suggestions for us.

One area often ignored in our efforts to reduce the deficit is economic growth. Despite the forecasts of many "experts", the economy grew at a rate of 6.8 percent last year, and at a 6 percent annual rate over the 2 years since the recession trough at the end of 1982—faster than any upturn since 1951.

The Budget Resolution for FY 1985, however, assumed that the economy would only grow by 5.4 percent—a full 1.4 percent less than reality.

I believe that the future depends on the economy growing faster than Government spending. The faster the economy grows, the less we need to cut in spending. And, the slower the economy grows, the more we need to cut in spending. By using both spending cuts and economic growth, we can successfully get the deficits under control. And, therefore, I believe that both are essential in our work on the budget this year.

Chairman DOMENICI. You may proceed, Dr. Penner.

STATEMENT OF DR. RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Dr. PENNER. Mr. Chairman, I am pleased to testify today before this committee on the outlook for the economy and the budget. With your permission, I will just summarize my complete statement and submit it for the record.

Chairman DOMENICI. It will be made a part of the record.[1]

Dr. PENNER. The rate of economic growth in calendar year 1984 was 6.8 percent, the highest since 1951. Despite the vigor of the economy, the deficit-to-GNP ratio in fiscal year 1984 was at 5.2 percent, the second highest in our postwar history, clearly illustrating the extreme imbalance in our fiscal policies.

Assuming historical rates of economic growth in the future, current law implies a steadily rising total deficit that nears $300 billion by 1990. The deficit does, however, remain constant relative to GNP at slightly more than 5 percent, which represents an improvement over last February's projection of a steadily rising deficit-to-GNP ratio.

This improvement results from the enactment of the "down payment" on the deficit during calendar year 1984. Although the deficit-to-GNP ratio has been stabilized, its high level implies rapid growth in the ratio of the outstanding debt to GNP throughout the project period.

This rapidly growing debt, in turn, implies a steadily growing interest burden that is itself a major component of our budget problem. More important, current fiscal policy suggests that the living standards of future generations of Americans will be gradually lowered compared with what they could be if fiscal policy were more prudent. CBO's projections imply that the economy will continue to expand in the face of a steadily growing debt burden. In fact, in the very short run, the growing deficit may even add slightly to the rate of expansion. Because the assumed combination of growing deficits and relative economic prosperity is without precedent in peacetime history, however, CBO's relatively optimistic economic projections must be put forward with considerable uncertainly.

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[1] See p. 93.

CBO ECONOMIC PROJECTIONS

More specifically, CBO's forecast calls for real growth to be about 3½ percent over the four quarters of 1985, and slightly less by 1986. The unemployment rate is projected to decline gradually to 6.9 percent in 1986. Inflation is expected to rise only fractionally, from about 4 percent last year to 4.6 percent by 1986.

The 3-month Treasury bill rate in calendar year 1985 is about one percentage point below last year, and rises only slightly in 1986. In its medium-term projection, CBO assumes that real GNP growth averages about 3.4 percent a year in the 1987–90 period. With these growth rates, the unemployment rate declines slowly to 6.2 percent in calendar year 1990.

Inflation averages 4.2 percent, while the 3-month Treasury bill averages 8.2 percent. The major uncertainties in the short run are related to inventories, oil prices, and interest rates. Some analysts fear that a reduction in output growth will be necessary this year to reduce inventory. Others expect that oil prices will decline more sharply than projected by CBO, a development that could have beneficial effects on both inflation and real growth.

Additional risks include a drop in capital inflows from abroad, leading to a decline in the dollar, a rise in domestic inflation and, increased pressure on interest rates.

It is also possible that repercussions could occur as a result of the financial stress being experienced in agriculture and other sectors. CBO does not believe that its short run forecast will be affected greatly by such events but much uncertainty surrounds the importance of such risks.

THE BUDGET OUTLOOK

Given baseline economic assumptions and no change in the budget policies now in place, CBO estimates that the total deficit, including off-budget spending, will rise from $214 billion in 1985 to nearly $300 billion by 1990, as shown in table 2.[1]

The projected total deficits for 1986 through 1989 are very close to those calculated 6 months ago. The 1985 total deficit estimate, however, has been raised by $23 billion, from $191 billion to $214 billion, largely because of lower than anticipated revenues, and a one-time increase to $13 billion in spending for purchases of Federal guaranteed notes issued by local public housing authorities. Perhaps the most important point that one can make about the spending side of the budget is that very few programs are responsible for the bulk of Federal outlays. Under CBO's projections, spending for national defense, Social Security, Medicare, and net interest would comprise 74 percent of total outlays and would be equivalent to 94 percent of total revenues by 1990.

The CBO baseline and OMB current services budget projections are very similar through 1988, as you noted in your opening statement, Mr. Chairman.

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[1] See p. 100.

OMB projects somewhat higher deficits for the 1985-87 period under its interpretation of current policies, and CBO projects higher deficits for 1989 and 1990. The projected total deficits for 1988, however, are almost identical—$249 billion for CBO versus $248 billion for OMB.

We are now examining those estimates in detail. On February 27 we will have a report analyzing almost line by line the President's budget.

The most important definitional difference, however, which you mentioned in your opening statement, involves national defense. The administration's number reflects the "Rose Garden" plan, which they used in the midsession review, while CBO uses the 1985 budget resolution authority targets for its baseline.

The OMB definition results in higher outlays through the projection period, ranging from $13 billion in 1986 to $21 billion in 1988. Budget projections however, are always somewhat speculative. Events may not work out as assumed, particularly the projected developments in the economy. The economy could perform either worse or better than CBO has projected. To estimate the possible variance for our baseline budget projections, we prepared two alternative paths.

Under a high-growth path, in which the economy matches the strong growth record of the 1960's, the total deficit would decline to $126 billion, or 1.9 percent of the GNP by 1990. Under a low-growth path, in which the economy undergoes a recession in 1987, similar to that of 1974-75, the total deficit would balloon to $425 billion, or 8.7 percent of the GNP.

THE ECONOMIC EFFECTS OF DEFICITS

My complete testimony discusses some of the major economic effects of deficits. Certainly one consequence of persistent deficits about which there seems to be little disagreement is their adverse effect on future generations. If deficits were financed entirely through domestic savings, rising Federal debt would supplant more and more private debt and equity in the portfolios of private investors.

Slower growth of the private capital stock would result in lower productivity than would occur with smaller deficits, and the income of future generations would be lower.

If the deficits were partly financed by inflows of foreign savings, that would imply a growing debt owed to foreigners. While investment could be maintained at higher levels than would be possible without the inflows, U.S. residents would enjoy a shrinking proportion of the production generated here because of rising interest and dividend payments abroad.

Thus, while reducing deficits may be painful for our generation, failure to reduce them will affect future generations. Of course, to what extent one chooses to benefit the current generation at the expense of future ones calls for a value judgment rather than an economic one.

GOALS FOR DEFICIT POLICY

There is no easy way to set a goal for deficit reduction. The traditional goal of a balanced budget seems out of reach in the short run. Moreover, because CBO estimates imply that the economy will be nearing full capacity by the end of the projection period, the goal of balancing the high employment budget is only slightly less difficult.

Further, I think there is a real danger in placing too much emphasis on any specific goal. The public might believe that anything short of that goal represents absolute failure, or that anything exceeding it represents unnecessary program cuts or tax increases.

The most important point to make about deficit reduction is that every little bit helps a lot because of the long-term indirect effect on interest costs. Given the interest rate assumptions underlying the CBO forecast and projections, a $1 cut in spending programs, or a tax increase of $1 lasting for the entire 1985 through 1990 period implies an interest saving during 1990 of over 70 cents.

The characteristics of the cut are also sometimes as important as its dollar value For example, it is relatively easy to cut spending in the short run by postponing the repair of public works. But such spending must be made eventually, and therefore the shortrun cut may have little relevance to the longrun fiscal problem. In contrast, a relatively small change in entitlements or tax laws may have little impact on deficits in the short run, but its effects may grow rapidly in the long run.

In theory, such a fundamental change should have more impact on financial markets than a cut that saves more money in the short run but is not sustainable.

DEBT-TO-GNP RATIO

Notwithstanding these important qualifications, it is possible to state a deficit reduction goal that has some appeal. As I noted earlier, a large part of the budget problem is related to rapidly growing interest costs that are, in turn, the result of a rapidly growing debt-to-GNP ratio.

If the debt-to-GNP ratio could be stabilized and then eventually reduced, the interest burden would begin to shrink relative to other spending and to tax receipts. A major part of the problem would thus be converted into a large part of the solution, and the budget dilemma would appear to be much more tractable.

If the ratio of debt to GNP could be stabilized in the last year of the budget resolution's 3-year planning horizon—that is to say, if the debt-to-GNP ratio at the end of fiscal year 1988 could be held to its level at the end of 1987—it is likely that it would decline in subsequent years. This goal implies a deficit of $145 billion in 1988, which could be attained with program cuts or tax increases of $30 billion in 1986, $55 billion in 1987, and $90 billion in 1988.

This is approximately the same time profile of cuts manifested by the downpayment on the deficit in 1984, although those cuts were smaller in magnitude. There are obviously a variety of time patterns of cuts that are consistent with the same 1988 goal.

If policy changes of the specified amounts were achieved, interest savings of $2 billion in 1986 and $14 billion by 1988 would also result. If market interest rates responded favorably to the plan, the interest savings would, of course, grow, and the debt-to-GNP ratio would already be declining in 1988.

The costs of delay are very high. If nothing is done in 1986, but the same plan were implemented in 1987, the interest savings in 1988 would be lowered by $8 billion. Just for comparative purposes, this saving would be equivalent to the amount that CBO projects will be spent in 1988 under current law on the whole budget function called Administration of Justice.

Again, I want to emphasize, that by describing one particular deficit-reduction plan, CBO does not wish to rule out plans implying more deficit reduction. The plan that I outlined would bring the deficit down, roughly speaking, to about 3 percent of the GNP in 1988. Two percent would obviously provide a much larger margin of error, if the assumptions turned out to be worse than CBO projects.

At this point I would be pleased to take your questions.

Chairman DOMENICI. Thank you very much, Dr. Penner.

[The prepared statement of Dr. Penner follows:]

PREPARED STATEMENT OF DR. RUDOLPH G. PENNER, DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, I am pleased to testify today before this Commitee on the outlook for the economy and the budget. We are releasing at the hearing this morning the new Congressional Budget Office report, The Economic and Budget Outlook: Fiscal Years 1986-1990.

The budget estimates contained in this report have not changed greatly from those published by CBO last August. The rate of economic growth in calendar year 1984 was 6.8 percent, the highest since 1951. Despite the vigor of the economy, the deficit-GNP ratio in fiscal 1984 was, at 5.2 percent, the second highest in our postwar history, clearly illustrating the extreme imbalance in our fiscal policies. Assuming historical rates of economic growth in the future, current law implies a steadily rising total deficit that nears $300 billion by 1990. The deficit does, however, remain constant relative to GNP at slightly more than 5 percent, which represents an improvement over last February's projection of a steadily rising deficit-to-GNP ratio. This improvement results from the enactment of the "downpayment" on the deficit during calendar year 1984. Although the deficit-GNP ratio has been stabilized, its high level implies rapid growth in the ratio of the outstanding debt to GNP throughout the projection period.

This rapidly growing debt, in turn, implies a steadily growing interest burden that is itself a major component of our budget problem. More important, current fiscal policy suggests that the living standards of future generations of Americans will be gradually lowered compared with what they could be if fiscal policy were more prudent. CBO's projections imply that the economy will continue to expand in the face of a steadily growing debt burden; in fact, in the very short run the growing deficit may even add slightly to the rate of expansion. Because the assumed combination of growing deficits and relative economic prosperity is without precedent in peacetime history, however, CBO's relatively optimistic economic projections must be put forward with considerable uncertainty.

RECENT ECONOMIC DEVELOPMENTS

Real GNP grew at a rapid 5.6 percent rate between the last quarters of 1983 and 1984, only slightly less than in the first year of recovery, and the unemployment rate declined to 7.2 percent by the fourth quarter of the year. Despite the sharp drop in unemployment, the inflation rate averaged about 4.0 percent during 1984, little changed from the moderate pace achieved in the previous year. Economic growth was led by rapid growth in consumer spending and a surge in business investment spending, both of which continued to benefit from the tax cuts enacted earlier. The lagging trade sector, however, remained a serious drag on the economy.

Economic growth was particularly strong in the first half of 1984, but slowed to a more sustainable pace thereafter. With reduced demands, interest rates declined and inflation remained moderate in the second half of 1984. At year-end, business firms also seemed to have had some success in reducing excess inventories. Thus, conditions now appear to be set for continued economic expansion with little increase in inflationary pressure.

THE CBO ECONOMIC PROJECTIONS

CBO's baseline economic projections are composed of two parts: a two-year forecast, conditional on specific policy assumptions; and medium-term projections, which show a smooth growth trend derived from average historical experience.

The Short-Run Economic Forecast

As in the past, CBO's economic forecast for the next two years incorporates an assumption of unchanged federal budget policies. In regard to monetary policy, the forecast assumes that the growth in the money aggregate M1 will be 5.5 percent from the end of 1984 to the end of 1985--the midpoint of the tentative target range announced by the Federal Reserve last July--and 5.0 percent in 1986. In addition to these policy assumptions, the price of imported oil is projected to average about $1.50 per barrel below last year's price and the value of the dollar in international exchange markets is assumed to decline moderately from current levels, so that its average value this calendar year will be about the same as last year.

Based on these assumptions, real growth is now forecast to be about 3½ percent over the four quarters of 1985 and slightly less by 1986. The unemployment rate is projected to decline gradually to 6.9 percent in 1986. Given this projected soft landing, inflation is expected to rise only fractionally from about 4.0 percent last year to 4.6 percent by 1986. The three-month Treasury Bill rate in calendar year 1985 is about one percentage point below last year and rises only slightly in 1986.

The Medium-Term Projections

In its medium-term projections, CBO assumes that from the fourth quarter of 1982 (the recession trough) to the fourth quarter of 1990 the growth of GNP and of labor productivity will be precisely equal to the average growth rate in eight-year periods following earlier postwar recessions. As a result, real GNP growth averages about 3.4 percent a year in the 1987-1990 period, and productivity growth in the nonfarm business sector averages about 2.2 percent. With these growth rates, the unemployment rate declines slowly to 6.2 percent in calendar year 1990. Inflation, as measured by the GNP deflator, averages 4.2 percent in the 1987-1990 period while the three-month Treasury bill rate averages 8.2 percent, or 4.0 percent after adjustment for inflation (see Table 1 and Figure 1).

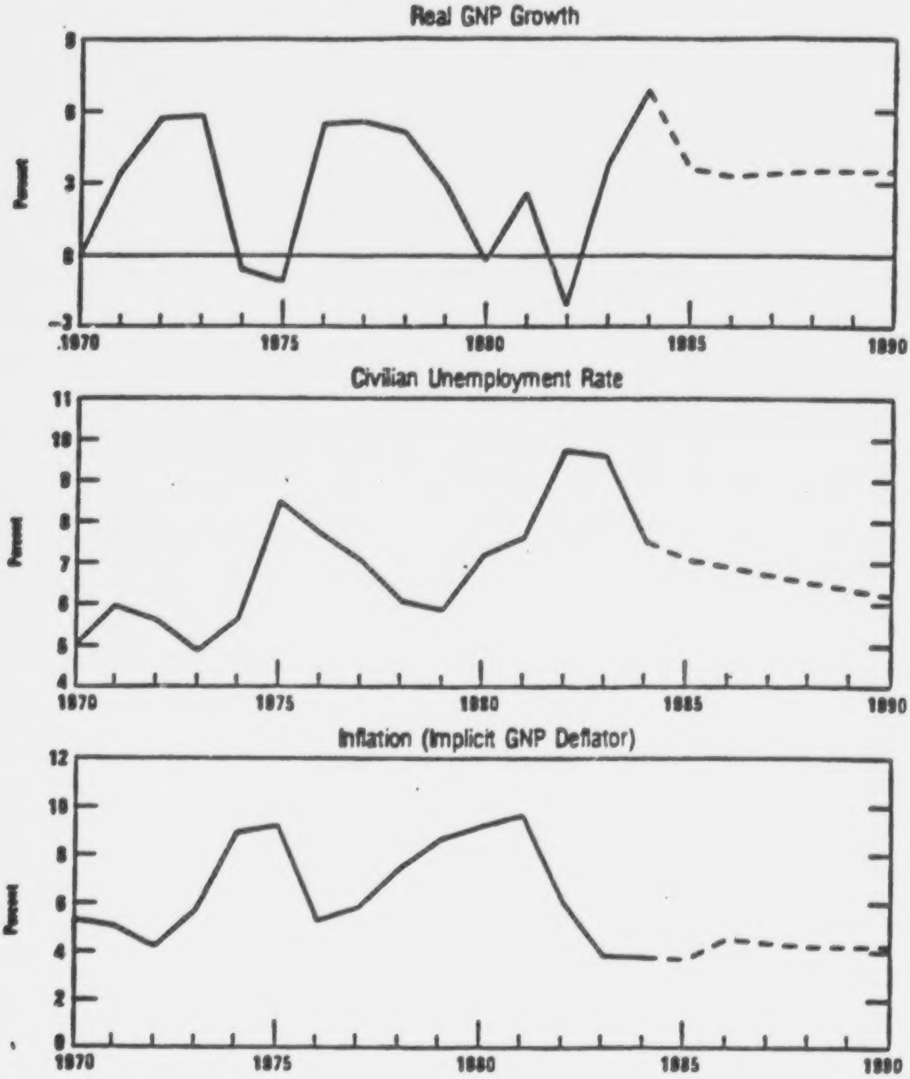
Uncertainties in the Economic Outlook

The economy's performance could easily turn out to be much better or worse than CBO's projections indicate. At present, the major uncertanties in the short run are related to inventories, oil prices, and interest rates. Some analysts fear that a temporary reduction in output growth will be necessary this year to reduce inventories. Others expect that oil prices will decline more sharply than projected by CBO, a development that could have beneficial effects on both inflation and real growth. Additional risks include a drop in capital inflows from abroad leading to a decline in the dollar, a rise in domestic inflation, and increased pressure on interest rates. It is also possible that repercussions could occur as a result of the financial stress being experienced in agriculture and other sectors. CBO has not included any such events in its short-run forecast. Although the baseline projection

TABLE 1. MEDIUM-TERM ECONOMIC PROJECTIONS FOR CALENDAR YEARS 1987-1990

	Actual	Forecast					
	1984	1985	1986	1987	1988	1989	1990
GNP (billions of current dollars)	3661	3927	4238	4567	4921	5301	5711
Nominal GNP Growth Rate (percent change, year over year)	10.8	7.3	7.9	7.8	7.7	7.7	7.7
Real GNP (percent change, year over year)	6.8	3.5	3.2	3.3	3.4	3.4	3.4
GNP Implicit Price Deflator (percent change, year over year)	3.7	3.6	4.6	4.4	4.2	4.2	4.2
CPI-U (percent change, year over year)	4.2	3.7	4.5	4.2	4.2	4.2	4.2
Civilian Unemployment Rate (percent, annual average)	7.5	7.1	6.9	6.7	6.6	6.4	6.2
Three-Month Treasury Bill Rate (percent, annual average)	9.5	8.3	8.7	8.2	8.2	8.2	8.2

FIGURE 1. MAJOR ECONOMIC ASSUMPTIONS



Real GNP Growth

Civilian Unemployment Rate

Inflation (Implicit GNP Deflator)

SOURCE: U.S. Department of Commerce, Bureau of Economic Analysis. U.S. Department of Labor, Bureau of Labor Statistics, Congressional Budget Office.

for the out-years does not explicitly incorporate a recession or an inflationary shock of any kind, it does not imply that such events will not occur. Because the timing of such events is impossible to forecast so far in advance, our projections simply smooth out real growth and inflation rates over the period. If it were certain there would be no recession, a somewhat higher annual growth rate would be appropriate.

THE BUDGET OUTLOOK

Given baseline economic assumptions and no change in the budget policies now in place, CBO estimates that the total federal deficit--including off-budget spending--will rise from $214 billion in 1985 to nearly $300 billion by 1990 (see Table 2.) Except for the current fiscal year, the budget outlook has not changed materially from CBO's projections last August. In fact, the projected total deficits for 1986-1989 are very close to those calculated six months ago. The 1985 total deficit estimate, however, has been raised by $23 billion--from $191 billion to $214 billion--largely because of lower anticipated revenues and a one-time increase of $13 billion in spending for purchases of federally guaranteed notes issued by local public housing authorities.

Despite the projected rise in the absolute size of the federal deficit, projected total deficits as a percentage of GNP for 1986-1990 under current laws and budget policies are fairly stable at around 5.2 percent--a sharp contrast to our projections of a year ago when the deficit was rising as a

TABLE 2. BASELINE BUDGET PROJECTIONS (By fiscal year)

	1984 Actual	1985 Base	Projections				
			1986	1987	1988	1989	1990
			In Billions of Dollars				
Baseline with Budget Resolution Defense Authority a/							
Revenues	666	735	788	855	934	1,005	1,088
Total outlays b/	852	949	1,003	1,088	1,183	1,276	1,384
Total deficit b/	185	214	215	233	249	272	296
Debt held by the public	1,313	1,526	1,740	1,972	2,220	2,490	2,786
			As a Percent of GNP				
Baseline with Budget Resolution Defense Authority a/							
Revenues	18.6	19.1	19.0	19.1	19.3	19.3	19.4
Total outlays b/	23.8	24.6	24.1	24.3	24.5	24.5	24.7
Total deficit b/	5.2	5.6	5.2	5.2	5.1	5.2	5.3
Debt held by the public	36.7	39.6	41.8	44.0	46.0	47.9	49.7
Reference: GNP (in billions of dollars)	3,581	3,855	4,158	4,483	4,830	5,204	5,606

a. Defense budget authority for 1986 and 1987 is assumed to be the amounts specified in the most recent Congressional budget resolution. Defense budget authority for 1988-1990 is an extrapolation of the budget resolution prepared for the staffs of the House and Senate Budget Committees. Outlays are estimated consistently with the assumed budget authority using CBO technical estimating methods.

b. Includes spending by off-budget entities, primarily by the Federal Financing Bank.

percentage of GNP. This improvement results from the enactment of the Deficit Reduction Act and other measures.

Baseline Projections

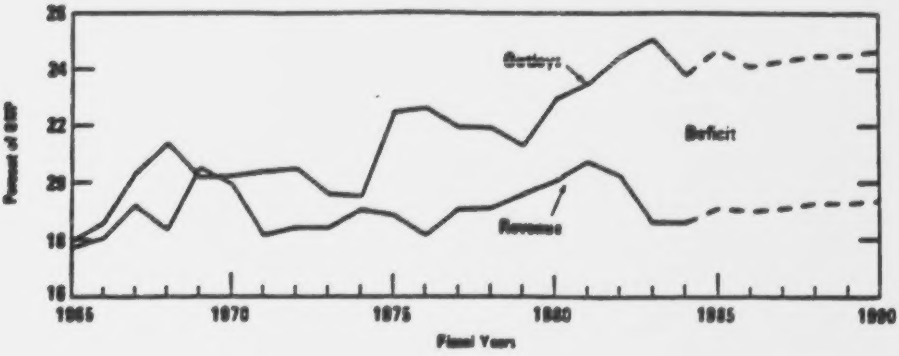
CBO's baseline projections are designed to show what would happen to the federal budget if current policies were continued into the future. For revenues and for entitlements and other mandatory spending items, current policies are largely defined by the laws now in effect. For discretionary spending, however, the definition of current policy is not as clear, since appropriations are made for only one year at a time. For our baseline projections of discretionary spending programs, CBO uses the following conventions:

- The baseline projections for nondefense appropriations are generally based on fiscal year 1985 funding levels as enacted by the 98th Congress, with future increases to keep pace with inflation.
- The projections for defense appropriations are based on enacted 1985 funding levels, with future increases to bring defense budget authority to the levels assumed in the 1985 budget resolution, as extrapolated through 1990. This means that defense budget authority would grow at an average rate of 5½ percent in real terms--after adjustments for projected inflation.

While these conventions do not necessarily represent a detailed program-by-program projection of the budget priorities and policies contained in the 1985 appropriations, they appear generally to be consistent with recent overall budget decisions.

Under CBO's baseline assumptions, revenues are projected to rise about 10 percent this year, to $735 billion, and to continue rising slightly faster than GNP through the remainder of the decade. As a percentage of GNP, revenues were 18.6 percent in 1984 and are projected to be 19.1 percent this year, rising to 19.4 percent in 1990. Total outlays--including off-budget spending--are projected to be nearly $950 billion this year and to rise to $1,384 billion by 1990. In the 1985-1990 period, federal spending under current policies would fluctuate in a narrow range between 24.1 percent and 24.7 percent of GNP, close to the 1983 postwar record (see Figure 2).

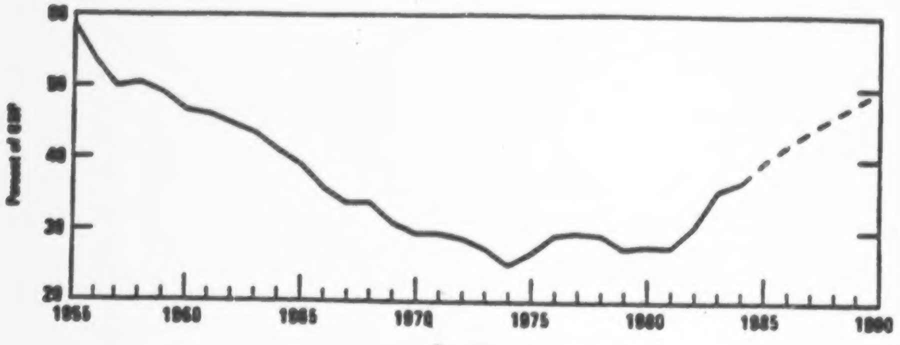
FIGURE 2. REVENUES AND OUTLAYS



SOURCE: Congressional Budget Office

The continued large and growing gaps between projected revenues and outlays means that federal borrowing needs will remain extremely large for an indefinite period. Under CBO's baseline assumptions, federal debt held by the public is projected to grow from $1.3 trillion at the end of fiscal year 1984 to $2.8 trillion by the end of 1990. This rapid accumulation of debt, which is outpacing the growth in the economy by a wide margin, would raise the debt held by the public as a percentage of GNP from under 30 percent during the 1970s to nearly 50 percent by 1990 (see Figure 3). An increase of this magnitude in the debt-to-GNP ratio has not occurred since World War II.

FIGURE 3. FEDERAL DEBT HELD BY THE PUBLIC



SOURCE: Congressional Budget Office.

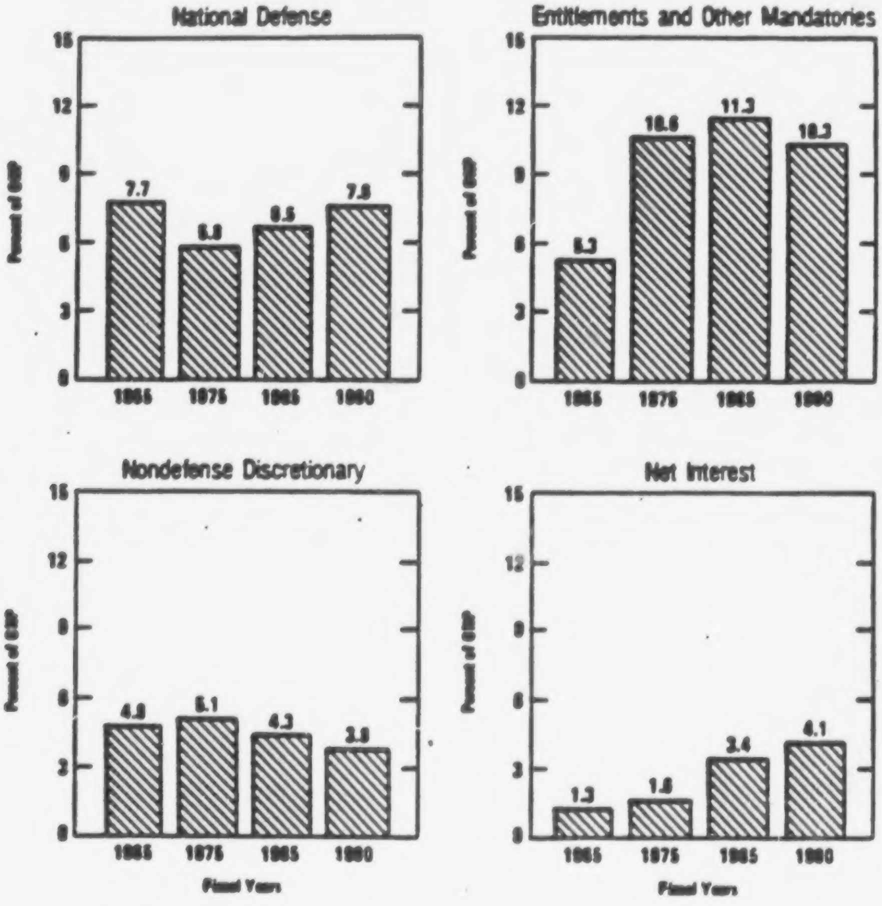
Changes in the Composition of Revenues and Spending

The composition of federal revenues is projected to change only slightly over the next five years if laws remain unchanged (see Table 3). Individual income and social insurance taxes and contributions are projected to constitute a record 83 percent of total revenues by 1990, continuing a long-established trend toward more reliance by the federal tax system on personal taxes. Corporate income taxes would also increase as a share of total taxes, from 8.5 percent in 1985 to close to 10 percent in 1990, but would still be far below the average of 21 percent in the 1960s and 15 percent in the 1970s. Reliance on corporate income taxes as a revenue source has been diminishing steadily as a result of legislated tax reductions and a general downward trend in the share of GNP going to economic profits.

Projected changes in the composition of federal spending under current policies are more substantial. The most rapidly growing category of spending in the baseline is net interest. With mounting borrowing needs and no reduction in inflation-adjusted interest rates after 1986, federal interest costs are projected to grow by $100 billion over the next five years, from $130 billion in 1985 to $230 billion in 1990. The net interest share of total spending would increase from 13.7 percent to 16.6 percent. In relation to GNP, net interest outlays have more than doubled in the past decade, rising from 1.6 percent of GNP in 1975 to 3.4 percent in 1985, and are projected to reach 4.1 percent by 1990 (see Figure 4).

Assuming that defense appropriations rise in line with the 1985 budget resolution targets for 1986 and beyond, national defense outlays would

FIGURE 4. THE COMPOSITION OF FEDERAL SPENDING



SOURCE: Congressional Budget Office.

TABLE 3. BASELINE REVENUE AND OUTLAY PROJECTIONS BY SOURCE OR MAJOR CATEGORY (By fiscal year, in billions of dollars)

	1984	1985	Projections				
	Actual	Base	1986	1987	1988	1989	1990
Revenues							
Individual Income Taxes	298	333	361	393	432	471	515
Corporate Income Taxes	57	63	71	88	96	102	107
Social Insurance Taxes	239	266	284	301	333	358	389
Excise Taxes and Other Revenues	72	74	72	72	72	74	77
Total Baseline Revenues	666	735	788	855	934	1,005	1,088
Outlays							
National Defense	227	252	282	313	347	384	424
Entitlements and Other Mandatory Spending							
Social Security	174	185	196	209	224	238	254
Medicare	61	69	76	85	95	107	119
Other	159	182	173	183	191	197	204
Subtotal	396	436	445	477	510	542	577
Nondefense Discretionary Spending	153	168	174	182	191	200	211
Net Interest	111	130	146	163	186	206	230
Offsetting Receipts	-45	-48	-52	-56	-59	-62	-65
Budget Outlays	842	938	995	1,080	1,174	1,270	1,378
Off-Budget Federal Entities	10	11	9	8	8	6	6
Total Baseline Outlays	852	949	1,003	1,088	1,183	1,276	1,384

increase by $172 billion during the next five years, from $252 billion in 1985 to $424 billion in 1990. Of this projected increase, $81 billion would result from the assumed real growth in defense budget authority, $62 billion from pay increases and other inflation adjustments, and $30 billion from previous increases in defense appropriations. As a share of total federal spending, national defense outlays would rise from 26.5 percent in 1985 to 30.7 percent in 1990. The ratio of national defense outlays to GNP would also increase substantially, reaching 7.6 percent by 1990, up a full percentage point from the 1985 level and almost two percentage points above the 1975 level, but still somewhat less than the 1965 level.

Nondefense programs would grow by $162 billion under current laws and policies, but would shrink in relative size. Most of these increases are to cover projected cost-of-living adjustments for Social Security and other indexed benefits, caseload increases, expected increases in medical costs, and inflation adjustments in discretionary programs. Because these increases are well below the rate of increase in total outlays, the share of the budget made up by these programs would decline from 60 percent in 1985 to 53 percent in 1990.

Perhaps the most important point one can make about the spending side of the budget is that very few programs are responsible for the bulk of federal outlays. Under CBO's projections, spending for national defense, Social Security, Medicare, and net interest would comprise 74 percent of total outlays and would be equivalent to 94 percent of total revenues by 1990.

Comparison of CBO and Administration Baseline Projections

The CBO baseline and OMB current services budget projections are very similar through 1988, as shown in Table 4. OMB projects somewhat higher deficits for 1985-1987 under its interpretation of current policies, and CBO projects higher deficits for 1989-1990. The projected total deficits for 1988, however, are almost identical--$249 billion for CBO versus $248 billion for OMB.

CBO is now examining the Administration's budget estimates to determine how much of the differences shown in Table 4 result from differences in the definition of current policy and how much from differences in economic assumptions or technical estimating methods. While the analysis will take us a few weeks to complete, it is clear that the Administration's economic assumptions produce more revenues and lower interest costs than the CBO baseline assumptions. The Administration's higher growth assumptions, and only slightly lower inflation assumptions, result in somewhat higher nominal GNP estimates throughout the 1986-1990 period, as shown in Table 5. These higher nominal GNP assumptions in turn produce marginally higher revenue estimates. Similarly, the Administration's lower interest rate assumptions result in lower interest outlays, especially in 1989 and 1990.

The most notable difference in the definition of current policy is for national defense. The OMB current services projections for national defense are last August's midsession review estimates reflecting the Rose Garden plan, while CBO uses the 1985 budget resolution budget authority targets for its baseline. The OMB definition results in higher outlays throughout the projection period, ranging from $13 billion in 1986 to $21 billion in 1988.

Uncertainty of Budget Estimates

Budget projections are always somewhat speculative. Events may not work out as assumed, particularly the projected developments in the economy. The economy could perform either better or worse than CBO has

TABLE 4. COMPARISON OF CBO BASELINE AND OMB CURRENT SERVICES PROJECTIONS (By fiscal year, in billions of dollars)

	1985	1986	1987	1988	1989	1990
Revenues						
CBO baseline	735	788	855	934	1005	1088
OMB current services	737	794	864	952	1030	1108
Difference	2	6	9	18	26	21
Total Outlays a/						
CBO baseline	949	1003	1088	1183	1276	1384
OMB current services	960	1025	1109	1200	1263	1333
Difference	11	21	21	17	-14	-51
Total Deficit a/						
CBO baseline	214	215	233	249	272	296
OMB current services	224	230	246	248	233	224
Difference	9	16	12	-1	-39	-72

a/ Includes off-budget spending.

projected. To estimate the possible variance for our baseline budget projections, we prepared two alternative economic paths. Under a high-growth path, in which the economy matches the strong growth record of the 1960s, the total deficit would decline to $126 billion, or 1.9 percent of GNP by 1990. Under a low-growth path, in which the economy undergoes a recession in 1987, the total deficit balloons to $425 billion, or 8.7 percent of GNP by 1990.

TABLE 5. COMPARISON OF CBO AND OMB ECONOMIC ASSUMPTIONS (By calendar year)

	1985	1986	1987	1988	1989	1990
Nominal GNP ($ billions)						
CBO	3,927	4,238	4,567	4,921	5,301	5,711
Administration	3,948	4,285	4,642	5,017	5,399	5,780
Difference	21	47	75	96	98	69
Real GNP Growth Rate (%)						
CBO	3.5	3.2	3.3	3.4	3.4	3.4
Administration	3.9	4.0	4.0	4.0	3.9	3.6
Difference	0.4	0.8	0.7	0.6	0.5	0.2
GNP Deflator (% change)						
CBO	3.6	4.6	4.4	4.2	4.2	4.2
Administration	3.8	4.4	4.2	3.9	3.6	3.3
Difference	0.2	-0.2	-0.2	-0.3	-0.6	-0.9
3-Month Treasury Bill Rate						
CBO	8.3	8.7	8.2	8.2	8.2	8.2
Administration	8.1	7.9	7.2	5.9	5.1	5.0
Difference	-0.2	-0.8	-1.0	-2.3	-3.1	-3.2

THE ECONOMIC EFFECTS OF DEFICITS

What are the economic effects of the deficits implied by the CBO projections? Economists cannot answer this question precisely. I will discuss three aspects of the deficits: their size in relation to historical savings trends, the costs associated with financing such deficits, and the impact of the build-up in government debt on the living standards of future generations.

Savings and Deficits

Since 1950, net private savings in the U.S. economy have averaged about 7.2 percent of GNP. State and local governments have registered an additional small surplus. Net foreign investment was negligible in this period. Federal deficits absorbed about 1.1 percent of GNP on a national income accounts basis, leaving total private and public saving available for domestic investment equal to about 6.5 percent of GNP (see Table 6). CBO's baseline budget projection for the 1985-1990 period now indicates that the federal deficit-to-GNP ratio in the 1985-1990 period will average 4.6 percent of GNP, on the same national income accounts basis. Thus, the share of net domestic savings absorbed by deficits would be many times higher than the average of the past, if savings behavior follows historical trends. Even with estimates of net private savings well above their level of recent years and state and local surpluses near their record high, only about 4.0 percent of GNP would be left for domestic investment. Thus, if

TABLE 6. NET SAVINGS AND INVESTMENT FLOWS AS PERCENTS OF GNP (NIPA Basis)

Period	(1) Net Private Domestic Savings	(2) State and Local Surplus	(3) Federal Deficit	(4) Net Domestic Savings Available for Domestic investment: (1)+(2)-(3)	(5) Net Private Domestic Investment	(6) Net Domestic Savings Shortfalls (5)-(4) = Net Foreign Investment
1950-1959	7.2	-.2	-.1	7.1	7.1	-.1
1960-1969	7.8	0	.3	7.5	7.0	-.5
1970-1979	7.2	.8	1.8	6.2	6.4	-.1
1980-1984 a/	6.0	1.3	3.9	3.4	4.1	.7
Average						
1950-1984	7.2	.4	1.1	6.5	6.4	-.1
1985-1990 b/	7.2	1.4	4.6	4.0	6.4	2.4

a/ BEA estimates are used for 1984 state and local surplus and 1984 federal deficit.

b/ Only the federal deficit is a CBO projection. Net private domestic savings and net private domestic investment shares of GNP are assumed for illustrative purposes to be at their averages of the 1970s, while the state and local surplus is assumed to maintain its high estimated share of GNP in 1984. Columns 4 and 6 are calculated from the other figures.

Details may not appear consistent with totals because of rounding.

investment spending only matched the historical average, the shortfall of domestic savings would be about 2½ percent of GNP.

This large gap between domestic savings and investment could be filled only by raising domestic savings sharply above the historical average, by attracting inflows of foreign capital of record proportions, or by reducing federal deficits. Otherwise, investment spending would be very weak.

Because savings with current policy are likely to remain scarce relative to planned investment, the competition for funds will be more intense. This will lead to high real interest rates since they are the reward paid to savers and a filter through which scarce funds are channeled for alternative uses.

Outlays for Interest on the Debt

As indicated earlier, if budget policies are not changed, the outstanding federal debt will rise dramatically. Federal spending for interest payments would also rise sharply, thereby limiting federal resources available for other spending programs. Just how fast interest payments will rise depends on the rate of growth of the outstanding debt and the level of interest rates. In CBO's baseline, net interest costs are the fastest growing category of spending, rising from $111 billion in fiscal year 1984 to $230 billion in fiscal year 1990.

If deficits become sufficiently high in the long run or interest rates rise significantly, interest costs may rise so rapidly that it is no longer politically feasible to offset their growth by raising taxes or cutting programs. At that point, there is a danger that the deficit and the associated debt outstanding will explode relative to GNP. Under these circumstances, there is a strong temptation to finance government by creating money rather than by further borrowing. The result would, of course, be highly inflationary. Fortunately, under current policies, the projected growth of non-interest spending relative to the growth in receipts is sufficiently low to offset the growth in interest costs and to stabilize the deficit/GNP ratio at slightly over 5 percent of GNP.

Long-Run Effects of Deficits

One consequence of persistent large deficits about which there seems to be little disagreement is their adverse effect on future generations. If deficits were financed entirely through domestic savings, rising federal debt would begin supplanting more and more private debt and equity in the portfolios of private investors. Slower growth of the private capital stock would result in lower productivity than would occur with smaller deficits, and the income of future generations would be lower. If the deficits were partly financed by inflows of foreign savings, that would imply a growing debt owed to foreigners. While investment could be maintained at higher levels than would be possible without the inflows, U.S. residents would enjoy a shrinking proportion of the production generated here because of rising interest and dividend payments abroad.

Thus, while reducing deficits may be painful for our generation, failure to reduce them will affect future generations. Of course, to what extent one chooses to benefit the current generation at the expense of future ones call for a value judgment rather than an economic one.

GOALS FOR DEFICIT POLICY

There is no easy way to set a goal for deficit reduction. The traditional goal of a balanced budget seems out of reach in the short run. Moreover, because the CBO estimates imply that the economy will be nearing full capacity by the end of the projection period, the goal of balancing the high-employment budget is only slightly less difficult. Further, there is a danger in placing too much emphasis on any specific goal. The public might believe that anything short of that goal represents absolute failure or that anything exceeding it represents unnecessary program cuts or tax increases.

The most important point to make about deficit reduction is that every little bit helps a lot because of the long-run indirect effect on interest costs. Given the interest rate assumptions underlying the CBO forecast and projections, a one dollar cut in spending programs or a tax increase of one dollar lasting for the entire 1985-1990 period implies an interest saving during 1990 of over 70 cents.

The characteristics of the cut are also sometimes as important as its dollar value. For example, it is relatively easy to cut spending in the short run by postponing the repair of public works. But such spending must be made eventually, and therefore the short-run cut may have little relevance to the long-run fiscal problem. In contrast, a relatively small change in entitlements or tax laws may have little impact on deficits in the short run, but its effects may grow rapidly in the long run. In theory, such a fundamental change should have more impact on financial markets than a cut that saves more money in the short run but is not sustainable.

Notwithstanding these important qualifications, it is possible to state a deficit reduction goal that has some appeal. As I noted earlier, a large part of the budget problem is related to rapidly growing interest costs that are, in turn, the result of a rapidly growing debt-to-GNP ratio. If the debt-GNP ratio could be stabilized and then eventually reduced, the interest burden would begin to shrink relative to other spending and to tax receipts. A major part of the budget problem would thus be converted into a large part of the solution and the budget dilemma would appear to be much more tractable.

If the ratio of debt held by the public to GNP could be stabilized in the last year of the budget resolution's three-year planning horizon--that is to say, if the debt-GNP ratio at the end of fiscal year 1988 could be held to its level at the end of 1987--it is likely that it would decline in subsequent years. This goal implies a deficit of $145 billion in 1988, which could be attained with program cuts or tax increases of $30 billion in 1986, $55 billion in 1987, and $90 billion in 1988. 1/ This is approximately the same

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1. The figures would be only slightly different if the debt target excluded Treasury securities held by the Federal Reserve System.

time profile of cuts manifested by the downpayment on the deficit in 1984, although those cuts were smaller in magnitude. There are obviously a variety of time patterns of cuts that are consistent with the same 1988 goal. If policy changes of the specified amounts were achieved, interest savings of $2 billion in 1986 and $14 billion by 1988 would also result. If market interest rates responded favorably to the plan, the interest savings would, of course, grow and the debt-GNP ratio would be already declining in 1988.

The costs of delay are very high (see Table 7). If nothing is done in 1986, but the same plan is implemented in 1987, the interest savings in 1988 are lowered by $8 billion. This saving is more than enough to finance the $7 billion that CBO projects will be spent under current law on the entire budget function entitled Administration of Justice in 1988.

Again, I want to emphasize that, by describing one particular deficit reduction plan, CBO does not wish to rule out plans implying more deficit reduction. If the debt-GNP ratio could be put on a declining path earlier, a greater margin of safety would result in the event that CBO's long-term economic assumptions turn out to be overly optimistic.

CONCLUSION

If the Congress is to reduce the deficit significantly, it must do this either by increasing tax burdens or by reducing outlays for major spending programs. The CBO publication Reducing the Deficit, which will be available on the 20th of this month, will provide the Congress with estimates of the savings that would be achieved with a wide variety of both spending and taxing options. CBO cannot recommend any one approach, of course, because such policies involve value judgments that are properly decided by the political process.

TABLE 7. THE COSTS OF DELAY (By fiscal year, in billions of dollars)

	1986	1987	1988	1989	Total
Policy Savings from Baseline					
Baseline	--	--	--	--	--
Path 1 (Start in 1986)	-30	-55	-90	-100	-275
Path 2 (Delay until 1987)	--	-30	-55	-90	-175
Interest Savings					
Baseline	--	--	--	--	--
Path 1	-2	-6	-14	-25	-47
Path 2	--	-2	-6	-14	-21
Total Deficit					
Baseline	215	233	249	272	
Path 1	183	172	145	147	
Path 2	215	202	188	168	
Debt/GNP (percent)					
Baseline	41.8	44.0	46.0	47.9	
Path 1	41.1	41.9	41.9	41.7	
Path 2	41.8	43.3	44.0	44.1	

Chairman **Domenici**. I am going to go ahead and yield on my side to the Senator from Washington, Senator Gorton.

ECONOMIC BENEFITS RECEIVED AS RESULT OF DEFICIT DOWNPAYMENT

Senator **Gorton**. Thank you, Mr. Chairman. Dr. Penner, would you tell me what benefits, if any, the economy of the United States has received, or, is likely to receive as a result of the downpayment on the budget deficit worked out by the Congress last year.

Dr. **Penner**. I think that the downpayment was very important. First, it was important in its quantitative magnitude, which was substantial, and more substantial as one projects it out in time because of the compounding effect on the interest rate that I mentioned earlier. Second, it gave the whole budget problem a different tone. Before the package was enacted, the deficit was actually rising faster than the GNP. In the sense of the arithmetic of the situation, that is the sort of situation that could explode. Indeed, with the deficit ever rising, it implies that the interest on the debt is just growing faster and faster all the time. You have to run faster and faster just to keep up. Indeed, in the extreme, although certainly we are far from it, we could reach a position where we simply could not keep up with it. Under these circumstances, there would be a strong temptation to finance government by creating money rather than by further borrowing.

By at least stabilizing the deficit-to-GNP ratio, we have created the prospect to stabilizing the debt-to-GNP ratio in the long run. Unfortunately, we stabilized it at such a high level, that it still means that the debt-to-GNP ratio has a very long way to go up before it slows down.

Senator **Gorton**. I would like to get this question down to a set of answers which have perhaps a greater immediate meaning to most people. Is it your view, that as a result of that downpayment, that interest rates are lower today than they likely otherwise would have been? Is there a difference in the rate of inflation. Is there a difference in the rate of real growth and/or is there likely to be in the future?

Dr. **Penner**. Rather than saying that interest rates are lower, I think the more important point to make is that capital formation is higher, simply because there has been somewhat less crowding out than would ordinarily be the case.

Now, the relationship between interest rates and that phenomenon is more controversial because we are dumping this into a huge international capital market, as well as into our own domestic markets. The interest rate effects needed to crowd in foreign capital, to increase capital formation, need not be huge and need not be easy to observe, as we point out in our annual report.

Nevertheless, I do believe that we probably benefited from the interest rate effect. I also think in the very long run—not this year or even next year or even 5 years from now—that the downpayment diminished the probability of inflation as well.

AMOUNT OF DEFICIT REDUCTION REQUIRED

Senator **Gorton**. What amount of deficit reduction is going to be required by the actions of this Congress to hold the ratio between debt and gross national product constant? Would the President's own budget do so?

Dr. PENNER. The President's own budget? Yes, sir. On the last page of my testimony, in table 7,[1] the line labeled "Path 1" under Total Deficit, shows the path to a stable debt-to-GNP ratio by 1988. That involves policy savings of $90 billion by 1988, which would also result in interest savings of $14 billion by that year.

Senator GORTON. Now, when you state that it has at least been a step forward, resulting from last year's downpayment, temporarily, at least, to hold that debt to GNP ratio constant, is that your preferred course of action, or, do you feel that, from the point of view of the good of the economy, that ratio should be on the decline?

Dr. PENNER. Well, I think that the usual package of proposals generally grow through time. Thus, if we could achieve stability by 1988, I think there would be a very good prospect that we could achieve decline later. In these calculations, we assumed no change in the baseline interest rates, whereas, from our previous discussion, I would suggest you could hope for some reduction in those rates as well.

So assuming that our fundamental assumptions are more or less correct, I think you could hope for a decline. What deficit policy should be involves a number of considerations. There is the risk that the whole situation could get away from us and be very inflationary. There are also the risks that result from depending so heavily on international capital markets. Those risks are important to consider. But leaving them aside just for analytic purposes, the really important issue involves the welfare of future generations versus the welfare of the present generation. CBO obviously can't venture a judgment on exactly where the political system should draw that tradeoff. But certainly in terms of the other two risks that I mentioned, I think it is clear that the more deficit reduction, the better.

Senator GORTON. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you, Senator. Senator Chiles.

Senator CHILES. I yield to Senator Sasser.

DO DEFICITS REALLY MATTER

Senator SASSER. Thank you, Senator Chiles. Dr. Penner, we have been talking about deficits in this committee, now, for the 7 years that I have been on the committee, and the question comes, Do deficits really matter? I am beginning to wonder. I mean, we have had unprecedented deficits, now, for 5 years. We are experiencing record economic growth. We seem to have licked inflation. The stock market is running at an all time high. Real disposable income in 1984 was at its highest in 20 or 21 years, and I have listened here, with great interest, and with great confidence in what they were saying, to economists of all shapes, sizes, and descriptions, from Alan Greenspan on one side to Walter Heller on the other, predicting gloom and doom for 4 years because of these high deficits. Now what is happening? Do deficits really matter? That is a fundamental question, and I think it is one that economists are going to have to address, because what our friends who are supposed to be masters of the dismal science have been telling us for the past 4 or 5 years, just have not come true. In fact, quite the opposite.

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[1] See p. 118.

How do you respond to that? Do deficits really matter?

Dr. PENNER. Well, sir, I think deficits matter a great deal. In 1981, when the Congress was passing the legislation, and I was testifying as a private citizen before this committee, and talking about the kind of deficits that would emerge from that legislation, they were so out of line with past history, that I must admit that I was perhaps more concerned than was warranted.

That does not mean, however, that deficits have not mattered. I think it does mean that we have not been able to see the effects of these deficits over time. If you have our annual report——

Senator SASSER. I do, indeed.

DEFICITS CREATE ECONOMIC PAIN

Dr. PENNER. And if you will turn to page 16, and if you will look at the real interest rates that we are experiencing today, as compared with the real interest rates in much of our postwar history, you will see how much higher they are today than we have been used to. Now, I do not want to claim these higher rates are entirely the result of the deficit, but I would claim that to a large degree they are the result of the deficit. The thing that I think surprised many economists, or at least surprised me, which I did not anticipate earlier, was the extent to which our ability to borrow from international capital markets would reduce the rise in real interest rates. I think they would have gone up even more, if we had not had this ability to borrow from international capital markets.

People who deal in those markets have been willing to lend us enormous amounts of money. Again, we at CBO think that a large part of that change is related to the deficit. That is to say, by pushing up real interest rates in this country, the deficit has been partly responsible for attracting that foreign capital. Other factors have played a role—political stability, for example. Even so, we think the deficit is important.

While the inflow of foreign capital has been very helpful in keeping interest rates down, and in keeping inflation down, it has imposed a very painful cost on certain segments of our economy. Because it has greatly raised the value of the dollar, it has made those sectors that compete in international trade very depressed, most particularly such sectors as agriculture, steel, autos, and so on.

Therefore, I think that while we have not had a calamity as a result of these deficits, I think that we are able to see their effects fairly clearly in what has gone on since we have had them, and that they have created pain in various parts of the economy.

EXODUS OF FOREIGN CAPITAL

Senator SASSER. Well, Dr. Penner, I agree with you. I see the pain that has been created with farmers in my native State of Tennessee, which is substantially an agricultural State. I see the pain that is created there in certain segments of light industry because of the overvalued dollar. They cannot compete against foreign goods coming into the country, and things like shoe factories, and clothing manufacturing facilities are closing. And if you go to Peoria, IL, and talk to the Caterpillar people, they will tell you that the overvalued dollar is simply killing them. But that is localized in this economy.

And when you look at the whole broad spectrum of the economy, things could not be better. And as an amateur economist, I wondered about this, and could it be that our economists are simply focusing on macro, domestic economics here, and have not yet shifted gears in to international macroeconomics. For example, capital flowing in to this country at unprecedented rates because of our political stability, and relative economic stability, that appears to be accelerating rather than decelerating, and I am not sure that it is really attracted here primarily because of high interest rates. That is one inducement. But perhaps a greater inducement is a stable political, and economic atmosphere. I am searching for some reason to explain why, in my judgment, our best economic minds have just been wrong, in my judgment, over the past 4 or 5 years, in the broad sense, and to the point that it is even being commented on now in some of the popular publications like, for example, Newsweek, I think, had an article about why are the economists all wrong.

Now let me ask you: What is going to happen in the event we do see an exodus of this foreign capital? We are financing what? About half of this deficit with capital coming in from abroad?

Dr. PENNER. It depends, where you start your baseline, but that is not a bad number.

EFFECTS OF FOREIGN CAPITAL EXODUS

Senator SASSER. All right. What happens to us, in your judgment, if we see an exodus of this foreign capital?

Dr. PENNER. We refer to it as foreign capital. But I think one thing that should be pointed out is that much of it is American capital that more typically would have gone abroad, and more specifically, much of it is in the multinational corporations, many of which are listed as American. But that aside, I think that there would be just the reverse of the beneficial effects that I mentioned.

If foreigners, or these international investors, for whatever reason, feel that they have got enough dollar assets now—they have been increasing their holdings at a very rapid rate—or indeed, if even worse, they decide to start selling some of those holdings, it is clear that interest rates would rise. Inflation rates would rise because the dollar would fall.

At that point, it would be a difficult question as to what the Federal Reserve would do, if faced with this series of circumstances, and particularly if it were abrupt. Would they feel a need to defend the dollar? It is hard to say. But if they did, it would push up interest rates even further.

One can easily create a scenario in which that very event would bring an end to this economic recovery. But to go back to your fundamental point, sir, I think that one of the things that really makes it difficult to endure the pain of reducing deficits is the very fact we can borrow from abroad. Just like a household, a country can live pretty well on borrowed money. No doubt about it.

Senator SASSER. We are living pretty well on borrowed money.

DEBTS HAVE TO BE PAID

Dr. PENNER. Yes. We are living very well on borrowed money, at least as long as the lenders are standing there ready to provide that money. But the point is, as our debts grow, somebody is going to have to pay those debts eventually, and it is probably going to be our children and our grandchildren. We are very slowly eroding their standards of living below what they would be otherwise.

The problem is that nobody notices this erosion. It is a very long process. In our annual report, in chapter III, we have some numbers on the economic consequences of deficits. It shows how long this process takes. But to say it takes a long time is quite different from saying it is unimportant.

Senator SASSER. Well, my time is up, Dr. Penner. At some juncture, I would like to explore this with you further. I think we are missing something in our economic analysis, and I do not know what the missing link is, but I expect some of you learned economists could come up with answers.

Dr. PENNER. I think you put your finger on it, sir, when you noted that the economists, early on, did not reflect on the fact that we are living in a world of almost perfect international capital markets, and that we are plunking our deficit into a much bigger pool than if it all had to be financed in the United States.

A $425 BILLION DEFICIT

Senator SASSER. Thank you, Mr. Chairman.

Chairman DOMENICI. I am going to ask Senator Symms to go next but I want to ask the witness a question. I did notice something in Dr. Penner's testimony that I think bears on the issue we are addressing. You said there were two deficit paths, in your prepared remarks, and one of the paths assumed that we did not have an era of growth and prosperity, but that we had a little downturn. My recollection of your testimony was frightening. You said that the deficits would reach $425 billion if—and would you tell us what that "if" is.

Dr. PENNER. That if was a scenario based on a recession occurring, starting in 1987. We constructed that recession, loosely speaking, to be very similar to the recession we actually experienced in 1974-75, which from peak to trough was the biggest recession since World War II.

Chairman DOMENICI. I only raised that point, Senator Sasser, not because any of the economic facts that you stated were wrong. I wanted to stress the point that all of this deficit accumulation could have a very deleterious effect on interest rates. Conversely, if you were able to reverse the deficit's path, you would have a salutory effect. I think as policymakers, even if we do not want to believe that the next generation is going to have a lower standard of living because of the deficit, I think we know it takes us a long time to act. It appears to me, that we do not have any backup so long as deficits are in the $280 to $290 billion range. The next time we have an economic problem—God forbid—but if we do, the deficits will reach almost half of the present outlays of our National Government for all of its programs. We are at a trillion. Dr. Penner's estimate is $425 billion in deficits. Frankly, I think we would be at a point where you could never get out of the dilemma that you are in. I do not know how you would get out of the economic downturn.

That is not urgent. It does seem to me it is rather startling, however. Senator Symms.

FOCUS MORE ON SPENDING CUTS

Senator **Symms**. Thank you, Mr. Chairman. I was interested in the questions that the Senator from Tennessee was asking, because I think he touches on a very important point, Dr. Penner.

I think that all of us in Washington, inside the beltway particularly, focus too much on the deficit and not enough on the spending side. We have this obsession, about deficit reduction, and what the deficit will do, and all these predictions on the deficit circulate. The problem, as I see it—and I offer the line, too, everybody does, and talk about how we have to reduce the deficit—is spending. I recall very clearly, a year ago, I offered a budget before this committee, to try to simply reduce spending down to $85 million an hour, a nice little amount of money. I just happened to notice last night on Cable News Network, that they showed a display about how much money the Government was spending during a 1 hour newscast. In 10 minutes, the Government had spent $17½ million, and in 1 hour, $105 million dollars had been spent.

And so when I think about this problem, and the effects of it, the economy has been doing pretty well in spite of excessive Government spending. Probably whether we borrow the money, print the money, counterfeit the currency by monetizing the debt, or raise taxes for it, all of these actions have a negative impact on the private sector.

Obviously, I have to agree with the chairman, that if we get in a recession again, at some time, this deficit could really get big. But I wonder if we should not be focusing more on good economic principles. What is your opinion of rewarding risktakers, and rewarding entrepreneurial activity, and not rewarding excessive consumption through our tax system?

In other words, we should take a look at some of those concepts, instead of just focusing on the deficit. I am all for spending cuts, do not get me wrong, but when we start talking about deficit reduction and getting it confused with raising taxes, I begin to think that either, first, raising taxes, monetizing the debt, or borrowing money, or all three are unsatisfactory ways of reducing the deficit in my judgment. The only proper way to do it is to cut spending. Would you want to comment on that, and problems in our economic forecasting, and so forth.

TAXES HAVE EFFICIENCY IMPACT ON PRIVATE SECTOR

Dr. **Penner**. I think you have made a number of different points. With regard to the choice between spending and taxing, it is quite obvious, that taxes do have an impact on the efficiency of the private sector. Obviously, it depends on what taxes. Some taxes do more than others. One can even think of ways of increasing taxes that add to efficiency.

On the Government spending side, there are also expenditures that add to the efficiency of the economy, capital expenditures, and so on. So that there is a very important question of composition here. But I think more important than that, is that our society is always facing a tradeoff between efficiency in the private sector, and the things that we want government to do for us—redistribute income, provide parks, do all sorts of different things.

No one goes to the extreme of wanting to finance government with the most efficient imaginable tax system, which would be a poll tax that people would pay whether employed or unemployed, and that would not affect their behavior. No one advocates that. On the other hand, I do not think anyone in the United States, advocates seriously a completely egalitarian system where the marginal tax rate would have to be 100 percent above some level. So in between that spectrum is a huge tradeoff between efficiency and our value judgments as to what government should be responsible for. Moreover, I think that within that spectrum, economists cannot say, "OK. This is exactly what you should do", because that would be a political judgment and not an economic one.

Obviously, economists can talk about the impact of a particular action on the efficiency of the private sector. In that respect, I would agree with everything you said, particularly, your allusion to the state of the tax system right now. Whatever amount we decide, as a result of these value judgments, is necessary to raise for government, I think that 99 percent of all economists, regardless of their ideology, would agree that we could raise that amount of money with much less impact on economic efficiency than is implied by our current tax system.

Senator SYMMS. Thank you very much. Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Hollings.

GROSS INTEREST COST

Senator HOLLINGS. Thank you, Mr. Chairman. Dr. Penner, one of the misleading statistics is the net interest rather than the gross interest costs. I remember in December, the Congressional Budget Office projected a gross interest cost for this fiscal year, 1985, of about $154 billion of last year going up to about $187 billion. That was a December 1 projection. The gross interest cost, in the month of December alone, was $23 billion. What is the projection for the gross interest cost for the fiscal year 1986?

Dr. PENNER. For 1986, sir?

Senator HOLLINGS. Yes, sir.

Dr. PENNER. $206 billion, sir.

NEW SPENDING PROGRAM

Senator HOLLINGS. The amount that we project is $206 billion. We are running a deficit of $214 to $215. That is over $500 million a day. So the first thing you have to do in the morning, to run the Government, is borrow $500 million. The next day, tomorrow, Thursday, we will have to do it again. And again on Friday, Saturday, Sunday. That is a shocking amount.

I think that people ought to understand that that is the new spending program. It will be jumping from—what is the 1985 figure? If $206 billion is the 1986 figure, 1985 would be what?

Dr. **Penner**. It would be $181 billion.

Senator **Hollings**. $181 billion. You have got that down. All right. So that, again—let us see—that is a $25 billion jump in interest costs. And that will jump this particular year $25 to $30 billion. We are doing so much spending, spending, spending, that we are launching a $25 to $30 billion new spending program for nothing, each year. I remember when I first got up here Senator Kennedy was going to have national health insurance that would have lost $30 billion. Our Chamber of Commerce friends wanted to catch him in a net because he was going to wreck the economy of America.

At least we would have had health insurance. Now we are just, each year throwing $25 billion down a black hole for interest costs. I think our colleagues ought to understand exactly what we are doing. Just because the interest rates are down, doesn't mean the deficit will take care of itself. I am looking at it budgetarily. That $25 billion, you know, we could be spending for cancer research, cracks in roads, and bridges, defense and everything else.

MEASURE OF UNEMPLOYMENT AND GROWTH

Your measure of unemployment, Dr. Penner, and growth, I have been told, is a budgetary affair, that 1 percent in growth will equal about $21 billion additional in revenues. Is that the good rule of measure? And a 1-percent increase in the—or, excuse me—a decrease in unemployment, would also equal about $21, $22 billion. Is that the measure we use in just looking?

Dr. **Penner**. The numbers are going up, of course, as the size of the economy and the budget are going up in nominal terms. The numbers that we have published on page 75 of our annual report show a 1-percentage-point change in unemployment affecting revenues by $20 billion.

Senator **Hollings**. How do we get that? Do that over slowly for me, because you have got unemployment going from 7.1 to 7.0 so it is $\frac{1}{10}$ of 1 percent, and that is my point.

Dr. **Penner**. I see.

Senator **Hollings**. How do you get to 20 rather than to 2?

Dr. **Penner**. I am sorry. I see.

Senator **Hollings**. I see it is only going from 7.1 down to 7. So that is about 2 billion rather than 20.

Dr. **Penner**. Yes. I misunderstood you, and I should not have used the $20 billion figure, sir, because that is based on a change in unemployment starting in January 1985. That is the 1985 number.

Senator **Hollings**. Right.

Dr. **Penner**. A more revealing figure would be the full-year effect in 1986, which would be $32 billion in revenues and $7 billion in outlays for a total of almost $40 billion.

Senator **Hollings**. You have got the entire year of 1986 going up to what? What is the unemployment rate for 1986?

Dr. **Penner**. For the entire calendar year of 1986, we have the rate at 6.9.

Senator **Hollings**. At 6.9?

Dr. **Penner**. Yes, sir.

BREAKDOWN OF REVENUES

Senator **Hollings**. So it goes from 7.1 to 6.9, down two-tenths. Again, I am still a little—I do not see how we pick up that much revenue. In other words, the growth is going from 4.1 to 3.2, 1985 to 1986. So, growth, you ought to be losing about $20 billion in revenues yet and you are increasing revenues. That is what I was trying to fathom, your revenue schedule oh—well, I missed the page now, but whatever it is, the breakdown of the revenues shows that in individual income taxes you pick up, my memory, is $28 billion.

Now that is not from inflation, because we have indexing. That is new people coming into the job market, but then you do not have that much in unemployment.

Dr. **Penner**. Remember, sir, that indexing means that the tax revenues in nominal dollars will just go up by the same amount as nominal incomes. Indexing simply prevents them from going up more than that amount through bracket creep as it used to. So there still would be a big increase in the number of nominal dollars as a result of the growth in nominal GNP.

Senator **Hollings**. Social Security comes in, some $12 billion Social Security is a big one now.

Dr. **Penner**. Yes, and because of the general prosperity of the economy. If you look at page 67 of our report, you can see that the personal income tax goes up quite a bit over time because the indexing does not affect the bracket creep caused by real income growth.

Senator **Hollings**. Well, I'd like to hear tonight about the "sunny times" that we are having, but it only goes up, really, because you are dropping excise and estate taxes. We are dropping some $5 billion there. We are picking up on Social Security taxes $12 billion, but only $28 billion in income taxes, individually, and $8 billion in corporate.

So that, really, our revenues increase only about $53 billion. Our outlays, according to your analysis $54 billion. So instead of $214 billion, you have got the deficit going from $214 to $215 billion, going up, instead of being lowered. Is that your analysis of President Reagan's budget, that the deficit goes up?

Dr. **Penner**. We have not yet recomputed the President's budget under our assumptions. It is a very complicated task.

Senator **Hollings**. Well, I saw—wait a minute—I saw in your statement here on page 7, of your particular presentation this morning, that the deficit in 1985 is $214 billion and you have projected for 1986, $215 billion.

Dr. **Penner**. Yes. I am sorry. That is under our definition of current policy which involves budget resolutions, defense and so forth.

Senator **Hollings**. Right.

Dr. **Penner**. Yes, sir.

Senator **Hollings**. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you, Senator Hollings. Senator Andrews.

FREEZE FOLLOWED BY 3 PERCENT NOMINAL GROWTH

Senator ANDREWS. Thank you, Mr. Chairman. Mr. Penner, the problems you have touched on are certainly grave, indeed, and that makes our decisions that much more difficult. One of the difficult decisions we face is knowing whether it is better to try to nickle and dime this deficit to death by looking at Davey Stockman's wish list, none of which probably, or certainly not more than a third of which are ever going to be adopted. And kind of absolve our consciences by saying we are looking at that. Or going the way that Senator Hollings and I have suggested, an in an across-the-board cut that gives us 30 billion dollars' worth of spending savings, and accompany it with $30 billion of revenue increases.

I have advocated the latter route because I have seen too much of this slipsliding and ducking that has been going on in the budget process. Everybody votes for a little of this and a little of that, and it never passes, but they then go home and say, "Well, do not blame me, it is that other guy."

Now I am sure you know what our package is, calling for a freeze in 1986 followed by a 3-percent nominal growth, matching every dollar, spending reduction of the dollar in revenue. In your general assessment of what we can expect in the economic environment over the next several years, how would this approach compare with the piecemeal solutions which have turned out over the last 4 years to be no solution at all?

Dr. PENNER. I think, that you are really again asking for a political value judgment which we cannot make.

Senator ANDREWS. No, but it ties in with your testimony because you said there is no easy way to set a goal for deficit reductions. "The traditional goal of a balanced budget seems out of reach in the short run." Those are your words.

Dr. PENNER. Yes.

BALANCED BUDGET BY 1990

Senator ANDREWS. Now in the program that the Senator from South Carolina and I have put together, our plan balances the budget by 1990. It is a positive one that people can understand. Would that not be a better way of getting these interest rates under control, doing the other things, than this wishing and wanting that has not gotten us anywhere for 4 years?

Dr. PENNER. I am trying to make a distinction between getting the deficit down, in which case I would certainly agree with you that more is better, without again contradicting what I also said—namely, that every little bit helps. Both statements are true, I think. How you should achieve that particular path, though, is what I think is a political value judgment. The most important arithmetic that bears on that question shows that four items of Government—national defense, Social Security, Medicare, and net interest—will comprise 74 percent of total spending and 94 percent of total receipts.

Senator **Andrews**. That is right, and our package addresses those functions, and it is the only one so far that does.

Dr. **Penner**. To the extent that the President's budget puts the two really big items—national defense and Social Security—off limits, then to attain any particular target, obviously, you have to make a real philosophical decision about what you think the rest of the Government should be doing. Within that limited area, you have to do very substantial things, as opposed to the various freeze concepts that shave off a little bit across the board.

DOLLAR FOR DOLLAR DEFICIT/SPENDING REDUCTION

Senator **Andrews**. But in coming up with this idea of hitting A, B, C, and D, all of which you know you are not going to hit, nobody is going to cut $500 million from NIH's budget to do research against cancer. Let us face it. There probably are not five votes in this Budget Committee to do that. You put a bunch of cuts together like that, you salve your conscience by saying you are for it, but you do not get anywhere. Now what we are doing with this across-the-board cut is, in effect by your own calculations, getting somewhere, and accomplishing the chore of getting these deficits under control by 1990. Now let us ask one other question. Is the dollar of deficit reduction that you would get from a tax increase as beneficial if it is matched with a dollar of spending reduction, as trying to do it all in spending reduction?

Dr. **Penner**. Again, I think economincally, it depends on the composition of the various dollars, but assuming that you are talking about across-the-board reductions, it does go right back down to the value tradeoff that I talked about before.

If you focused only on the efficiency of the private economy, then lower tax burdens would be better. But that obviously is not all we focus on. We are constantly trading that objective off against the various social goals that are appropriate for government. So as a staff person, I cannot answer the question in terms of looking at the whole global picture.

It depends on one's political philosophy—or ideology, if you like—as to what one thinks government should be responsible for and what it should not be responsible for.

MAXIMUM DEFICIT REDUCTION BETTER

Senator **Andrews**. Is there any difference in future growth between the President's budget approach and our budget approach?

Dr. **Penner**. I think to the extent that you lower the deficit more, there is a difference in terms of the effect again on either private capital formation or international inflows. More is better, in terms of the growth of the private sector.

Senator **Andrews**. Mr. Chairman, I am going to quit right now when he says ours is better than the President's. I think we have gotten the right kind of an admission. Now if my colleague over there would have been listening to all these great things, we would have had another arrow to put in our quiver and go shoot at those naysayers that do not want to do it practically.

But I do not know of any other way of doing it, and if somebody—have you, Doctor, any idea of how better you can get these deficits down than an across-the-board freeze that does in fact and indeed impact those big monsters of defense and entitlements?

Dr. PENNER. Again, I have to repeat, sir, that the question of just how you do it requires a political value judgment. What is better, really depends on what the people out there want their government to do for them.

Senator ANDREWS. But the best thing to get interest rates under control, and take care of this economy, is to get the maximum reduction in the deficit?

Dr. PENNER. Yes. I think that is true. Now let me again go back to my qualification, which is that it depends on the composition of the reduction. What we have been talking about are general across-the-board sorts of things. It is possible to imagine a particular kind of tax increase that would be so inefficient that it would be worse than the deficits. Similarly, it is possible to imagine a particular kind of spending reduction that is so inefficient—one that affects essential capital investment, for example—that it is worse than the deficits. But we have been——

Senator ANDREWS. But you do not see either of those——

Dr. PENNER [continuing]. Posturing in general terms about across-the-board——

Senator ANDREWS. But you do not see either of those in the across-the-board cuts, in the revenue enhancement that we have proposed in this program, do you?

Dr. PENNER. No, sir, not in terms of extreme inefficiencies.

Senator ANDREWS. Thank you much.

Chairman DOMENICI. Let me just clarify something now. Your contention, as I heard it here, Senator Andrews, is that there were not five votes on this committee to reduce the deficit by doing such things as cutting the cancer research $500 million?

Senator ANDREWS. Mr. Chairman, I said that around this table, I would guess when push comes to shove, there would not be five votes to cut back the research against cancer and heart diseases and stroke at NIH. I do not think that is a realistic cut. I do not think it is a cut that is going to fly.

NEW TAXES IN ANDREWS PLAN

Chairman DOMENICI. Well, let me ask you: how much new taxes does the Andrews plan have in the first year, and how much over 3 years?

Senator ANDREWS. Well, you can call them new taxes. We call them tax recovery——

Chairman DOMENICI. Oh. I understand.

Senator ANDREWS [continuing]. But whatever it is, it is $30 billion. We match $30 billion——

Chairman DOMENICI. How much the next year?

Senator ANDREWS. It gradually grows. The next year I think goes on in tax savings to get us in to the neighborhood of $45 billion.

Chairman DOMENICI. All right And then it gets to $58 sometime?

Senator ANDREWS. Yes, but matched by additional tax——

Chairman DOMENICI. I understand I just want——

Senator ANDREWS [continuing]. Or spending cuts which get us down, Mr. Chairman, to a deficit of $28 billion in that fourth out year. Ain't nobody else got a program like that around.

Chairman DOMENICI. Well, I understand, but what I want to get at is your assessment of where the votes are. Now let me see if I could say this, and say it in all graciousness: The Andrews plan has $30 billion in tax increases in fiscal year 1986 followed by how much, the next year?

Senator ANDREWS. $45 to $50 billion.

Chairman DOMENICI. And then $50 to $58 billion?

Senator ANDREWS. $58 billion.

Chairman DOMENICI. All right. So I would merely say, that I do not know if there are five votes on the floor of the Senate, much less around this table, for $30, $80, $130 billion in new taxes.

Senator ANDREWS. Hey, now, wait, Mr. Chairman.

Chairman DOMENICI. Well, I just make my statement. You made yours.

Senator ANDREWS. Fine. But you say on the floor of the Senate for this package. I do not know whether——

Senator CHILES. Can I get a chance to question Dr. Penner at any time here?

Chairman DOMENICI. Yes. You are next.

Senator ANDREWS. Mr. Chairman, let me answer that just this way: That we have been introducing this, this is the fourth year, and the last time around we got 38 votes for the package, that is more than any other package, and it was a combined package of tax hikes and spending cuts. And let me also say, that I do not know about the folks down in New Mexico, but the people out in North Dakota think that the toughest damn tax of all is the tax of high interest rates, and if they have got to pay a little more in taxes to get those interest rates down, to balance this budget, they are all for it.

Now we will see, when we get on the floor of the Senate, whether we have got the 38 votes we had last year but each year we have indeed, and in fact increased. And we will see how it goes on that basis.

Senator GORTON. Did the people of North Carolina vote for a tax increase in November?

Chairman DOMENICI. That is all right. We want to yield to the distinguished Senator from Florida, and we will just let all of this evolve in due course. Senator Chiles.

Senator CHILES. I thought maybe the markup was starting 2 or 3 weeks early here.

Chairman DOMENICI. Well, we were——

Senator CHILES. We are ready. We are ready. I do not know about the rest of these guys.

Chairman DOMENICI. We are ready.

DEFICITS IN THE RANGE OF $170 BILLION

Senator CHILES. Dr. Penner, I started off in my opening remarks talking about whether you could just simply have a freeze, across-the-board, without other action. That would get the deficits down in the neighborhood of supposedly $170 billion in the third year. Do you think deficits in the range of a $170 to a $180 billion for the next 5 years, really does the job for us?

Dr. PENNER. Well, again, I reiterate: every little bit helps a lot because of the relationship I explained earlier—the compounding relationship to the interest bill. On the other hand, more is better It does not, this particular path, associated with a comprehensive freeze, does not even get you to the point, which was in the example I gave you in my testimony, the point where the debt-GNP ratio stops growing.

Obviously the interest savings would be impressive from a freeze and would grow in the future. But even so with this praticular path the interest bill would still be likely to be rising relative to our tax revenues and relative to the rest of the budget.

EFFECT ON REVENUES OF POLICY CHANGES

Senator CHILES. I thank you. I am looking at page 154, table D3 in your book and table D4.

I am trying to determine where our deficit has come from and what makes up this deficit now. Looking at those numbers from 1982 through 1990 shows me that as a result the original tax bill we had in 1981, we lost $335 billion revenue, or we will through 1990. That is not a total. That is in the year 1990, as I understand. Is that right?

Dr. PENNER. Yes, sir. This is not one of my favorite tables in our document. First of all, I see a typo in it, which I had not noticed before. The top line should be moved over 1 year.

The problem with the table in general is that it involves very, very large changes in policy, and it calculates their effect as though those changes in policy inspired no other action. But in the very simpleminded way that if everything else had remained equal, the value of ERDA would have been $335 billion in 1990.

Senator CHILES. All right. And the next few columns show because of revenue in the Tax Equity and Fiscal Responsibility Act of 1982, we would pick up $53 billion in 1990. The Surface Transportation Act would pick up $5 billion. The Social Security Amendments of 1983, mean $21 billion. The repeal of the withholding tax on interest dividends, lost $2 billion. The Dividend Reduction Act of 1984, picked up $30 billion.

So the net effect from all these changes is a loss of $228 billion. That is what we would have had, had we not enacted the massive tax cut. In Mr. Stockman's testimony yesterday, he said "We had a big tax cut in 1981 but we made up all of that. We are back to where we would have been before." But we did not quite get back to where we would have been before. We are back to 19.1 percent taxation maybe. We were not at 19.1 percent taxation when we made that tax cut.

EFFECT ON UNIFIED BUDGET OUTLAYS OF POLICY CHANGES

Mr. Stockman's testimony failed to deal with that. He talked about it from a historical level. Now, if you look at table D4, in 1990, we are adding $95 billion to defense by legislative actions. We have subtracted $27 billion from nondefense discretionary spending, and $56 billion from entitlements and other mandatory spending. So we really get a wash there.

We have added $95 billion to defense. We have subtracted $93 billion from the domestic side. And then we have a couple of other offsetting receipts, but the effect of legislative actions on interest costs then is $123 billion.

Is that the combined effects of the tax actions that we took as well as the legislative changes on the program changes? Is that right?

Dr. PENNER. That is right, sir.

Senator CHILES. So, we have $123 billion more interest in 1990, based on the tax changes that we made in 1981, the "wash" in defense, and the other items. So basically, that interest change is a result of the interest we are paying because the massive tax cut was made with borrowed money?

Dr. PENNER. Yes. Now a very large part of the tax cut, of course, was the indexing of the personal income tax.

Senator CHILES. Right.

Dr. PENNER. Now in the absence of that indexing, who knows what the Congress would have done? At least through the 1970's, there were periodic discretionary cuts in taxes that more or less kept the tax burden the same. But just taking it very literally, your interpretation is correct.

EFFECT ON UNIFIED BUDGET DEFICITS OF POLICY CHANGES

Senator CHILES. If we go over to your table D2, on page 153, it shows the effect of the unified budget deficits on policy changes since 1981. We see changes $228 billion from tax reduction. Defense spending means $95 billion added to the deficit. Non-defense spending cuts, put back $88 billion. That is almost a "wash" there. The effect of the legislative actions on interest cost is $123 billion. So our total change in the year 1990 is a minus $359 billion. Based on those figures it looks like our tax reductions amount to, over the years 1982 to 1990, a trillion, one hundred and eighty-one million.

The defense spending increases is $410 billion. The non-defense spending cuts total $551 billion. The interest cost is $404 billion. So in effect those particular legislative actions would have added one trillion, four hundred forty-four billion to the debt?

Dr. PENNER. In effect, they would have, but again under the very artificial assumption that absolutely nothing else would have changed had we not done all of those things.

TWO THINGS NECESSARY TO KEEP ECONOMY HEALTHY

Senator CHILES. Right. If we do not get this debt down to, in the neighborhood of 2 percent of the GNP, what are the risks that we run, you know, as you see them?

Dr. PENNER. Well, perhaps I should put it the other way. If we do go ahead with the deficit——

Senator CHILES. Well, I would like to hear that, too.

Dr. PENNER. Two things are necessary to keep the economy performing well as we describe in our economic assumptions. First, domestic and foreign investers would have to be willing to increase their holdings of U.S. Treasury bills and bonds, and so on, at enormous rates, approximating 15 percent per year, and you have to assume that that could happen without a major increase in real interest rates. Second, we would have to keep drawing on the international capital markets, and you have to assume that these international players would continue to add to their holdings of dollars assets at rates higher than their increase in holdings of other currencies.

If either of those underlying assumptions are not true, a problem could arise. As I mentioned before, I think the biggest risk in the system stems from the possibility that we will abruptly lose that inflow of international capital. If that were to happen, it could, as I described before, lead to a scenario that actually converts the recovery in to a recession. Other than that possibility, I think it is obvious that, though we have had 2 years of really excellent economic recovery, there are parts of the economy, perhaps most importantly right now, agriculture, that are in a fragile state. They are in that fragile state partly, though not entirely, because of high real interest rates.

Therefore, anything that one can do to get real interest rates down would clearly reduce the risks emanating from sectors of the economy that are in a fragile situation.

And we do believe, as I said before, that deficit reduction would start to lower those real interest rates. In our projections, we keep them more or less constant through the whole period.

CBO'S BASELINE DEFICIT ESTIMATE HIGHER

Senator CHILES. If I might ask just one more question. In your testimony, you indicate that CBO's baseline estimate deficit is about the same as the President's for fiscal year 1988, and about $72 billion higher than his estimate for 1990.

After making adjustments for the differences in the two defense baselines, your baseline deficit is about $20 billion higher than the President's in fiscal year 1988, about $90 billion higher in fiscal year 1990.

OMB estimates that the President's budget would yield a deficit of $144 billion in 1988, and $82 billion in 1990. Speaking in very rough terms, is it not likely that your reestimate of the President's budget deficit will be higher by about $20 billion in 1988 and $90 billion in fiscal year 1990, yielding estimates of a hundred and sixty-five to a hundred and seventy billion in both years?

Dr. PENNER. I would prefer not to actually put specific numbers on the table before actually doing the job, which is very detailed, but certainly our estimate will be higher, given our economic assumptions.

Senator CHILES. Well, is it not true that the President's budget would yield deficits that are higher than he says, and that his deficits are stabilized at the higher level rather than declining?

Dr. PENNER. I think there you get into an argument over the veracity of these economic assumptions. I think it is very important to make the point that CBO is formulating its economic assumptions on the basis of current policy. We are not allowed to assume that policy will change or to forecast any change in policy.

The President, of course, is projecting the economy on the basis of his policy, and he would not advocate his policies, obviously, unless he thought it would make the world a better place.

So the economic assumptions are not strictly comparable in that regard. Even if they were, the administration's assumptions in the short run, as I have noted before, are really very close to CBO's, given typical forecasting errors; in the long run, there is just the one major difference, and that is the interest rate projection.

Senator CHILES. That causes his numbers to be about half of what you say his numbers would be, though, in 1990?

Dr. PENNER. I am not sure what you are applying the half to, sir. Is it the interest bill you are talking about?

Senator CHILES. No. I am talking about on the deficits.

Dr. PENNER. The administration's current services deficit is 224 and CBO's is 296, and so I would expect comparable differences—not exact differences, but comparable differences.

Senator CHILES. Now I was talking about fiscal year 1990, the President's estimate is about an $82 billion deficit and——

Dr. PENNER. But that estimate includes his policy changes. Their current services estimate, given their assumptions, is $224 billion, with their definition of defense current services.

Senator CHILES. Right. But if we add the differences in baselines to their policy changes, would you not have come up with about a $170 billion deficit in 1990?

Dr. PENNER. I would prefer not to say right now, until we actually do the job.

POLICY CHANGE WOULD AFFECT ECONOMIC ASSUMPTIONS

Chairman DOMENICI. Dr. Penner, let me just follow up on that. We must decide whether we are able to do the President's $50 billion deficit reduction package, or one similar with a different mix, that has more out-year savings than his. One of the problems we have is that we must take economic assumptions that are current policy economic assumptions.

Would it not seem to you, that a policy change like the one I have just described, all on the expenditure side, a mix of defense and all other programs, and some program terminations and the like, is a large enough change in policy to have some significant effect on the economic assumptions a year and 2 years out? Or should we continue to use current policy economic assumptions in the third year? One of the problems you have got with Senators is, you tell them you are making a dramatic change, and then you go back and use the same economics that were in when you started, and they are kind of saying, "Why do it? Does not the world change any?"

Dr. PENNER. Yes. Now, the policy you are asking about is the comprehensive freeze type of policy.

Chairman DOMENICI. Freeze plus enough to get 50. Just for hypothetical purposes.

Dr. PENNER. Obviously, a policy change of that kind would affect the economic assumptions. But that is one issue which economists battle tooth and nail as to exactly how it would affect the assumptions, how it would be manifested, and so on. I think, however, they would all agree in the same direction, maybe disagree a lot about quantities. But they would agree, for example, that interest rates would go down as a result of a policy change of that magnitude.

OUTLAYS DIFFERENT BETWEEN OMB AND CBO DEFENSE TRENDLINES

Chairman DOMENICI. I just have two more questions. I have had my staff outline the outlay differences between the OMB defense trendline for 1986 and 1987, and CBO's and we have a rather significant difference in the outlay assessment due to reestimating of outlays. My staff tells me that there is a $7 and $8 billion dollar outlay differential in 1986 and 1987. Can we, without abusing the deference that exists between the two entities, have for OMB and CBO to compare notes there, and give us some concerted view as to why?

Dr. PENNER. Well, I am not sure. I can, however, tell you what has been going on from our point of view. We have had in recent years a constant problem of overestimating the outlays that go with any particular level of budget authority.

We have taken a very careful look at the problem and we have lowered our estimate somewhat below, for example, the assumptions made in the budget resolution of last year.

Chairman DOMENICI. Well, why do we not do this?

Dr. PENNER. Everything that has happened in the first 3 months of the fiscal year suggests to us that our estimates are pretty much on track.

BUDGET AUTHORITY NUMBER FOR DEFENSE

Chairman DOMENICI. All right. Let's do we not do this, then, if you would. We do not have to do it now, but would you return to us for insertion in the record in response to this question, a description of what you did and how you did it. All right? Then the chairman will submit a question to OMB using those descriptions and ask them why their outlays are what they are, and why yours are what they are, and maybe we will get the answer.

[The following was subsequently supplied for the record:]

The Administration's current services projections for 1986-1990 are taken from the August 1984 Mid-Session Review of the 1985 budget, with no change in the outlay estimates to reflect the shortfalls in defense spending that occurred in 1984 or to reflect out-year effects of appropriations for 1985 below the assumed amount. The CBO baseline projections were constructed by developing a zero-growth base from actual 1985 appropriations and adding a real growth component so as to match exactly the 1985 budget resolution targets for the national defense function for 1986-1987, and extended to 1990 in consultation with Budget Committee staff. The real growth component was assumed to be largely for purchases of equipment from routine supplies to weapons procurement and Research and Development (R&D). The outlay estimates for 1986-1987 were revised from those contained in the budget resolution to reflect the spending shortfall in 1984 and actual outlay patterns for the first quarter of fiscal year 1985.

Some of the differences between the administration's current services outlay projections for national defense and the CBO baseline can be attributed to policy differences and the rest of technical estimating differences. The policy differences are reflected in the higher levels of budget authority in the Administration's current services projections that in the CBO baseline. The technical estimating differences result from the use of different spending rate assumptions. These are summarized in the following table.

COMPARISON OF ADMINISTRATION CURRENT SERVICES AND CBO BASELINE PROJECTIONS FOR NATIONAL DEFENSE

[By fiscal year, in billions of dollars]

	1986	1987	1988	1986–88 total
Administration current services:				
Budget authority	333.6	371.9	421.4	1,127.0
Outlays	294.6	330.4	368.5	993.4
CBO baseline:				
Budget authority	324.7	359.8	397.8	1,082.3
Outlays	281.9	313.2	347.0	942.1
Difference (administration/CBO):				
Budget authority	8.9	12.1	23.6	44.7
Outlays	12.7	17.2	21.5	51.3
Source of outlay difference:				
Policy-higher BA	2.9	7.0	13.4	23.3
Technical—different spending rate assumptions	9.8	10.2	8.1	28.0

Source: Congressional Budget Office.

The technical estimating difference appears to be caused primarily by the failure of the Administration to update its current services outlay estimates for 1985 appropriation action and recent spending experience. CBO estimates that the Administration's current services outlay estimates for 1986–1988 are too high by $8 billion to $10 billion in each year, given the Administration's assumed budget authority levels. This conclusion is supported by the fact that CBO has very small technical differences with the outlay estimates in the President's budget for 1986–1988 for the Administration's latest policy proposals for defense programs. These technical differences amount to only $1 billion in 1986 and $2 billion in 1987, as discussed in Appendix B in CBO's "An Analysis of the President's Budgetary Proposals for Fiscal Year 1986" (February 1985).

Chairman **Domenici**. Now, my last question is this: We are being told, while we continue to work with authorizing committees, and appropriators, that we are definitely not a line item committee. We have to come up with a budget authority number for defense, be it a target or a mandate or whatever. We are constantly being told—let me just use a hypothetical.

Yesterday, Mr. Stockman clearly said, and I am sure tomorrow Cap Weinberger will say it, and I am sure other Senators say it: "For those who think we could live with a BA freeze in defense, tell us what it will or will not do. Tell us what we have to give up or not give up."

Now, clearly, while we do not base a budget authority figure on any of those specific conclusions, it is obvious to this Senator that we have to back up any such decisions, whether it is 3 percent real growth on whatever—with some kind of "Here's how it might work scenario."

Could you tell me what we would have to give you in order for your analysts to tell us, in a reasonable manner, what those kind of hypotheticals would do to the Defense Department?

What else would we have to ask you, besides this general question? For instance, I would like to assume, just for starters, that we make no cuts whatsoever in the President's strategic requests.

If we cannot do this now, could you tell me what we would have to submit, as a committee, to you, for your analysts to tell us the consequences of hypothetical decisions.

Dr. **Penner**. I think we could work that out between our respective staffs. We could work out with them the savings implications of different packages of options that would get you from, let us say, the budget authority, and the resolution of last year, to a freeze, or to some sort of freeze.

Chairman DOMENICI. All right.

Dr. PENNER. I should also point out that on February 20, we will be releasing our report, which has a great array of budget reduction options in it, well, a portion of which are related to the defense budget.

Chairman DOMENICI. All right.

Dr. PENNER. So with these various resources, I am sure that we can talk about the implications of different packages—what they mean, in general terms, to the risk we take, and so on.

Chairman DOMENICI. All right. I had decided that maybe I would turn the meeting over to Senator Quayle, but he is going to have difficulty with time, so I will remain. I do have just two more questions but I will just remain and ask them. Senator Exon and Senator Quayle had been here waiting a long time, and I do not think you would mind if we went to Senator Quayle. Senator Quayle.

REDUCE DEFICIT BY TAX INCREASES OR SPENDING CUTS

Senator QUAYLE. Thank you, Mr. Chairman, and Senator Exon. Dr. Penner, I see that you are not going to make a recommendation on whether we ought to reduce the deficit by tax increases or through spending cuts. Your claim that that is more of a judgment and policy decision.

Are you saying, then, that it would not make any difference, to economic growth whether we close this deficit, now about 5 percent of GNP, by, say, all tax increases or all spending cuts?

Certainly there must be some economic response to whichever the Congress did. But by just reading this, I certainly have the impression that you are saying it does not really make any difference from an economic point of view whether we raise taxes or cut spending. Am I reading you correctly?

Dr. PENNER. I think the point is, Senator, of course it makes an economic difference to the private sector, just how we do things. It makes a difference, not only in general terms, of whether it is on the tax or spending side, but it makes a difference in terms of what taxes, what spending. Different ones have different efficiency effects on the private market.

As a nonpartisan staff person, I am only trying to say that though those things do have effects on the private sector, we are always in the position of trading off those effects to achieve certain other social goals through government, and that is the decision we cannot make.

Senator QUAYLE. But as a nonpartisan staff person, also, is there not going to be a different reaction, in the markets, and in the private sector, depending on whether this deficit gap is closed by spending reduction or tax increases?

Dr. PENNER. Oh, yes.

FOCUS ON ECONOMIC GROWTH

Senator QUAYLE. Correct me if I am wrong—I would think that if your preference would be for economic growth to continue, to get a positive reaction in the markets, and to see interest rates continue to come down, that we ought to do it by spending cuts rather than tax increases.

Is that not a concensus of what the private sector would say they would like to see?

Dr. **Penner**. If the single thing that you are focusing on is the economic efficiency of the private sector——

Senator **Quayle**. Our goal is economic growth because if the economy grows we have more jobs, more opportunities, and more prosperity. That is what we want.

Dr. **Penner**. If that is the single thing that you are focusing on, then you are absolutely right. What I am suggesting, however, is that it is not the single thing that the political system focuses on. The system is always making tradeoffs between the goals of economic efficiency and growth in the private sector, and certain other goals that are satisfied through the public sector like income redistribution, for example.

Senator **Quayle**. But if we would just focus on economic growth, to see the GNP expand, then in fact would I say that reduction in spending should be the strong preference and the priority? Do you agree with that?

Dr. **Penner**. If that is the only focus.

REDUCE OR ELIMINATE PROGRAMS TO REACH BUDGET GOALS

Senator **Quayle**. If that would be the goal. Dr. Penner, there has been much discussion in the past, that if we just go ahead and freeze some things, and nibble at the edges of others, that we might be able to get from here to there. Now that the discussion has come out—I think our chairman has said it more than once—you cannot just freeze, you are going to have to go beyond the freeze. If you are really looking at a $50 billion reduction, and if you are really looking at serious deficit reduction by spending cuts, are we not basically talking about some fundamental program elimination within the Federal budget?

I am not asking you to identify those programs because I know that you do not want to, but from a general point of view, are we not really saying that we are going to have to eliminate some of the Federal programs that we have had, if we are to reach our goals of $50 billion in 1986 and higher goals in the outyears?

Or can we reduce the deficit by nibbling at the edges? You know, restraining growth a little bit here, cutting defense a little bit more? Add a bit to nondefense as the Congress will do, change the mix a little, nibble around and say, "Well, we have done our work," and go home and not have any substantive changes?

Dr. **Penner**. Total spending in 1986 is a little over $1 trillion. I think the $50 billion comes from the President's baseline which is higher. But forgetting that for the moment, if you are to cut $50 billion, that is 5 percent of a trillion dollars. It does mean more cuts in some programs than in others, because you cannot cut interest on the national debt. Some programs are bound by contracts, and so on. But in theory, you could make some kind of calculation of those areas where you have flexibility, and sure, you could get that amount across the board.

Senator **Quayle**. But from a long-term budgetary perspective, in order to permanently reduce the growth curve in Government spending, isn't it necessary to eliminate and reform programs this year? Is that not a budgetary fiscal reality rather than just saying we are going to hold the growth down for a few years?

Dr. **Penner**. I do not think that is necessarily so. I mean, you may be building some sort of other political framework onto it, and saying that if you actually eliminate something there will be less likelihood of it being increased at some time in the future. If that is the sort of thing you are thinking of, there may be merit to it.

TRIMMING EDGES TO REACH GOALS

Senator **Quayle**. I guess what I am thinking of is that to not only stabilize the ratio of debt to GNP, but to see it reduced to 4, 3, and then 2 percent of GNP, it just seems to me—although you are somewhat hesitant to agree to that—that you are indicating we can achieve these goals just by trimming at the edges. Is essentially what you are saying?

Dr. **Penner**. Well, again, I return to what I have called the most important arithmetic in this document, and that is, that just those four programs, Defense, Social Security, Medicare, and net interest will comprise——

Senator **Quayle**. Seventy-five percent, seventy-four percent?

Dr. **Penner**. Seventy-four percent of the budget, and more important perhaps, well over 90 percent of the receipts we project out there. So you have got great big programs, and you have got a whole hoard of little programs making up the rest of the Government.

So obviously, if you take $5 billion out of a great big program, for example, you do not have to change the fundamental philosophy of that program in any particular way.

On the other hand, if you take $5 billion out of a small program like, let us say, Aid To Dependent Children, that would be about half that program. To do that you would have to make a fundamental change in the goals of that program.

To me, that is the essence, of the arithmetic. It does not mean, however, that you could not achieve a certain goal by making a really broad sweep of things.

Senator **Quayle**. Thank you, Dr. Penner, and I thank the indulgence of the Chair and Senator Exon.

NEW TAXES DEFY POLITICAL HISTORY OF COUNTRY

Chairman **Domenici**. Senator Quayle, let me remind you of what the Budget Director said yesterday. He said taxes have nothing to do with economics; they have to do with politics. The last election said we should not increase taxes. That is true. But that is not what he was talking about.

What he was saying was this: for those who think that you can get deficit reduction and stay there by imposing substantial new taxes, you are defying the political history of the country. You may get new taxes but you will just end up are taking them off. We have never left them over 20 percent of GNP and we are at 19.3 percent.

And so for those who think one approach versus another is real or unreal, I submit that what Mr. Stockman is suggesting is that history reveals if you put a big tax on, $30, $40 billion, and it goes to $60 and you say "We have got this deficit under control," beware, because people will not leave it in place very long. And then you will take it down. I think that is the message in the history lesson. It may be that people have changed. I think the last election may reveal people have not changed, but I think that is what he was saying.

OBJECTIVE IS ECONOMIC GROWTH

Senator QUAYLE. What I would like for us to leave the political arena so we can discuss what is best for the economy. I mean, we know what the politics are, we know the outcome of the last election and what the President's statements were. I would like to concentrate on the economic question I asked Dr. Penner. If our objective is economic growth in the private sector: Now how do we achieve economic growth in the private sector? What is the effect of tax increases versus spending restraints on growth? That is what I would like to see the discussion turn to.

Chairman DOMENICI. Senator Exon.

REDUCE STRATEGIC DEFENSE INITIATIVES

Senator EXON. Thank you, Mr. Chairman. Let me just comment on your worthy suggestion that we ask CBO, and I congratulate you, Dr. Penner, and the people who have been in your position previously. I think you have done an outstanding job, you know, to try to keep everybody honest, including the administration, and I think the CBO is doing the job that it was created to do.

The chairman suggested that you might do a study on how we might be able to get our defense matter under control. As the chairman knows, and the ranking member, I also serve on the Armed Services Committee and on the Strategic and Theater Nuclear Forces Subcommittee thereof. If, as the chairman suggested—and I do not think he meant that ironclad—but he suggested that we talk about reducing defense expenditures and leaving the strategic defenses alone. Then there is no use in doing a study. The main increase in the defense budget, the increase, I emphasize, has been through strategic defense initiatives that have gone wild. I think that we have been fooled to an extent, although maybe not completely, those of us on the Armed Services Committee, or those of us around this table.

We have fooled ourselves over the years that we have made reductions in the amounts recommended by the Pentagon and various Presidents. The facts of the matter are those reductions have not been real reductions at all. All they have done is stretch out a few programs, and in the end, we have that bulge coming at us in the next 2, 3, 4, 5, 6 or 7 years, basically, with our continued strategic defense initiative—whether those are good, or bad or indifferent, we are going to have to spend more on defense, in my opinion, unless we get in to the strategic defense itself, and I would suggest that we start out with the MX, which I think is unnecessary and unworkable, and an unthinkable $30 billion boondoggle. But that is my opinion. Some people do not agree.

CANNOT GROW OUT OF DEFICIT

I just want to cover a few points with you, briefly, if I might. I was pleased to see, Dr. Penner, that you had said that we cannot grow our way out of this deficit. I guess basically that means that, while, if the economy remains healthy, and actually we are going to take in more money, in revenue, than we would if the economy was in a deep recession. Is that a fair way of putting it?

Dr. **Penner**. That is true, and to be more precise, I should say that we certainly should not rely on growing our way out of the deficit. If by that you mean achieving a balanced budget, I suppose it is possible but it would take a recordbreaking economic growth to do it.

Senator **Exon**. Would it be fair to characterize that, then, by saying that the "Laffable" curve is pretty laughable?

Dr. **Penner**. I am not sure I would use language like that, sir, but essentially, I think the arithmetic basically speaks for itself. We referred, in my testimony, to our high path. In very general terms, that high path refers to the period of the most sustained recovery since World War II, but even that path leaves you with a deficit at the end of the period equal to 1.9 percent of GNP.

DEVISE PLAN TO REDUCE DEFICIT

Senator **Exon**. What is, in your opinion, Dr. Penner, these magical figures that we place in our mind. You know, there was a downpayment on the deficit, you know, just a few months ago. That downpayment evidently was more than eaten up. While we were making the downpayment, the deficit was going up. What is this magical figure of $50 billion, now, which seems to be, is a worthy goal. Do you think sometimes we get hung up on $50 or $30 billion, or downpayments? My point is, would it not be better if we could devise a plan that is going to take 6 or 7 years, in my opinion, to gradually reduce this deficit over a period of years? Where did the $50 billion come from? I am sure you did not invent that.

Dr. **Penner**. I think you make a very, very important point. Indeed, I suggested in my testimony that there is some danger in thinking of specific figures, because once one conveys a certain amount of magic along with a particular figure, one might say, "If we cannot get that amount, why do anything at all?"

Whereas, in fact, every little bit helps. I would suggest that the downpayment helped a lot. It really changed the nature of the problem from one in which the deficit was rising faster than the GNP, to one where we have at least stabilized it, albeit at an extraordinarily high level but at least we stabilized it.

To talk about particular deficit targets, I think, we need some sort of framework. But one should not put too much emphasis on targets because they are so sensitive to the economic assumptions that they will just jump around all the time. The important thing is to engage in some kind of action. That may, whatever the outcome, at least we will be able to say that we are better off than if we did not act at all. You know, we may be lucky with the economy and we may do very much better than we expected. On the other hand, we may be unlucky with the economy, and there might not be any apparent effect on the deficit.

Nevertheless, it is important to think of where we would be if we had not acted in the first place. We would have clearly been very much worse off under those circumstances. So I think the point you are making is extremely important. That is not to say we should not talk about specific numbers. Of course, I did it myself earlier in the testimony. I mentioned very specific numbers that happened to achieve a certain goal under our baseline. Obviously, we need those numbers to give us some framework for our discussion, my point is that we should not become obsessed with them.

KEYNESIAN ECONOMIC THEORY

Senator EXON. One last point I would like to make, Mr. Chairman, just a series of questions that I think you can answer very briefly. As we look to the future I think we can maybe get something from history, economic history, and I would like to maybe analyze very briefly, how is it that we are in this economic recovery that we are in right now, and what caused it? Let me ask you this question: Has not economic history generally told us, Dr. Penner, that when we have a rapidly increasing deficit which is the understatement of the morning, do we not generally see during that period, and for a short time thereafter, a generally booming economy? In other words, an infusion of money into the economy that creates a feeling of euphoria, at least for a period of time. Is that generally true?

Dr. PENNER. I think that is what Keynesian economic theory would suggest.

Senator EXON. Have you ever seen a time when Keynesian economic theory is running more wild than it is today?

Dr. PENNER. Well, we have never done what we are doing now, before.

Senator EXON. Amen.

Dr. PENNER. It is a little hard to refer back to history. We have never had a situation in which, in the face of assumptions of pretty good economic growth the deficit rises. Whether those assumptions are right or wrong is almost beside the point. The fact is that even if you assume good enough growth to bring down the unemployment rate, the deficit goes up under current policy.

That is very unusual. I do not think it has been true of any other period in our economic history. So that is why I said that, while our assumptions are really pretty optimistic about the short-run future, and indeed, about the future through 1990, we just have to put them forward with a great deal of uncertainty, simply because we are dealing with something that is not precedented, historically, in peacetime. I should add that important qualification. We have, in fact, done this sort of thing in wartime.

Senator EXON. Likewise, have we not generally had the "good times rolling," when we had massive increases in national security? I mean is that not a great stimulant?

Dr. PENNER. I think that is correct, and the two are closely related, usually. By the way, we have never had a buildup of our defense forces in peacetime for such a sustained period as we are undergoing right now.

TAX CUTS IMPORTANT

Senator **Exon**. And the final point that I would like to make to complete this triad: Have we not always had "good times rolling" when we have had massive tax cuts? And no one can deny that we have not had those. I mean, is that not the third part of this triad, and is not that triad that I am trying to explain briefly here, the main reason for the way we have the "good times rolling" in certain sectors of our economy today, at least?

Dr. **Penner**. We think that the tax cuts were very important in very specific sectors. Just to give you one example, most certainly investment was stimulated far more than it would have been otherwise, had we not undertaken those depreciation changes in 1981. I say "more than otherwise" because our calculations suggest that, for equipment investment at least, the effects of that tax cut almost exactly offset the effects of the rise in real interest rates that we experienced over the same period.

Senator **Exon**. Thank you, Mr. Chairman. Thank you, Doctor.

STRATEGIC INCREASES

Chairman **Domenici**. Thank you very much, Senator Exon. Dr. Penner, let me just make two observations, and one before the good Senator Exon leaves. When I made the point about the strategic initiative, I was not passing judgment on what we should or should not do.

Senator **Exon**. I understood that.

Chairman **Domenici**. On the other hand, I would suggest, that if you look at the percent of the administration's budget that is strategic, it is about 13 percent of the total defense budget. If you look at the President's request for increases, you'll see that while the budget is going to go up $30 billion in outlays, a very little portion of that, almost none, is attributable to any increases in strategic areas.

Senator **Exon**. You mean further increases. Further?

Chairman **Domenici**. Further. Correct. That is because the B-1 is coming down, as you know, in terms of budget authority. I was only trying, up front, to answer the question of how we affect the Geneva talks if we vote in any restraint? I am assuming that there would be a far more genuine concern about their strategic inventory than other types of inventory. That was my only reasoning.

STABILIZING THE DEFICIT

Dr. Penner, I have just one observation. The example that you give about stabilizing the deficit, in your example, and your overall discussions with us here about the historic nature of the American economy are very interesting. The United States is relying to a great extent upon world money coming in to finance the deficit. I think one could also assume that since that itself is historic, and it is not without some problems out there in the world. Relying on foreign money itself is very dangerous.

I mean, we see that Third World countries, and even developed countries, with the exception of Taiwan and Korea, a few like that, are having tremendous difficulties because of the world drain on money coming to the United States. The trade deficit is related.

So it seems to this Senator that that is just going to continue because the whirlpool of money is working for us for the first time, moving all in our direction. I guess I am concluding that the need for more significant deficit reductions than you have suggested in your example, is clear to me. I am not saying you oppose greater reductions.

Your concern is that we will set our sights too high, and if we cannot reach the goal, we will not do much of anything. Am I correct?

Dr. PENNER. Yes, I think that would be a disaster.

DEFICIT GOAL

Chairman DOMENICI. Yes. I do not want to leave the record stating that an $8 billion outlay reduction off the President's baseline in the first year is not terribly relevant. I think it is, because the original idea of the $50 billion reduction was to follow it with policy changes that would reduce the deficit as a percent of GNP in half.

The President's budget does not get there. Originally, the plan was to get there. It is obvious why he did not get there. Because in the outyears there are no reductions in defense; the downward path goes up again. You get $50 billion savings in the first year, but you do not get the outyear effect. That is what happened, it appears to me.

Our goal is going to be to reduce the deficit as a percent of GNP to 4 percent in 1986, 3 percent in 1987, and 2 percent in 1988. We start with $50 billion savings in outlays. Now, you do not find fault with the goal, do you?

Dr. PENNER. No, sir. I guess one of the difficult things in all this discussion is how we define cuts and increases. It becomes a semantic issue, and very confusing after awhile. In the example I gave—and it is no more than that—we defined the cut as being $32 billion. But as you have noted just in passing, we had better be sure we are not confusing people, because when you talk of a cut of $50 billion, you are talking about a cut from a higher base—because of the $8 billion difference in the defense part of that.

We tend to discuss these things in a very confusing way. But my basic point is that I would still suggest, just as I concluded the testimony, that nothing in that example I gave was intended to imply that more would not be better.

I misspoke a moment ago, Mr. Chairman. The defense baseline difference is $13 billion, not $8 billion. So taking that into account, very crudely speaking, all by itself, makes our figure $45 billion.

Chairman DOMENICI. And that 13 differential is in outlays. Yes, that is correct. Is that not right?

Dr. PENNER. That is right.

Chairman DOMENICI. All right. Given the policies that are recommended by the President, do you think his economic forecast in that budget is unreasonable?

Dr. **Penner**. No, sir. This year, we, very bravely, I think, have published a record of our own forecasting errors, and the two forecasts are within an average forecast error of each other, almost on every dimension.

Chairman **Domenici**. Thank you. Now if there are any further questions, we will submit them to you in writing. We will have a few, and any of the other Senators that want may submit them. Answer them as quickly as you can. I know you have a big workload.

We stand in recess.

[Whereupon, at 12:22 p.m., the committee adjourned.]

Written Questions From Senator Kasten to Dr. Penner and the Responses

Senator Kasten. Dr. Penner, do you have any estimates of what a 1-percentage-point increase in the annual growth of the economy would save?

Does this assume an increase in inflation? Why? I don't think it should. Our experience of the last few years proves that we can have significant growth without inflation. Just last year, we had growth of 6.8 percent—1.4 percent more than we assumed in the budget—and inflation was under 4 percent. Does it assume a reduction in unemployment as a result of economic growth? Why not?

Dr. Penner. We prepared two kinds of estimates regarding the sensitivity of the budget to economic assumptions: one kind is designed to mirror typical interactions among major economic variables. Thus, we prepared a high-growth path and a low-growth path, as alternatives to the baseline. The second type of estimate involves the development of rough rules of thumb for gauging the effects of changes in individual economic variables taken in relative isolation.

In CBO's high-path alternative to the baseline, economic growth from the recession trough in the fourth quarter of 1982 to the fourth quarter of 1990 is assumed to equal the strongest eight-year recovery in the postwar period—that experienced in the 1960s. This assumption results in an average annual growth rate of 5 percent over the period compared with 4 percent in the baseline projection. According to CBO's budget projections, the high-growth alternative yields a deficit that is $25 billion below the baseline in fiscal year 1986, with the difference growing to $170 billion lower in fiscal year 1990. Even with the high-growth path, however, the estimated deficit would still amount to approximately 2 percent of projected GNP in 1990.

In CBO's high-growth alternative, inflation and interest rates rise rapidly in the out-years compared with the baseline. The rationale is that such rapid growth would strain the capacity of the economy, even with very optimistic assumptions about faster productivity growth. In the high-growth path, unemployment averages less than 6 percent in 1987 and less than 5 percent in 1990. (Such sustained rapid growth in the 1960s was not experienced without rising inflation and interest rates.)

With CBO's rule-of-thumb calculation, annual rate of real growth of one percentage point higher beginning in January 1985 would reduce the deficit by $19 billion in fiscal year 1986. The differential in the deficit would grow to $128 billion in fiscal year 1990. This rule-of-thumb calculation does not consider most interactions among economic variables, although it does include the effect of faster growth on unemployment.

Senator Kasten. Dr. Penner, do you have any suggestions for how we can achieve a one-percentage-point increase in economic growth?

Dr. Penner. The connections between policy actions and sustained economic growth are not understood well enough for one to suggest a list of policy changes that would raise the trend growth rate by a percentage point. It would, however, be very difficult to achieve this magnitude of increase through policy initiatives--that would be a very large increase in the trend-rate of growth. A policy strategy for attempting to raise substantially the long-run growth rate would probably have to involve many policy initiatives, rather than just a few. One of the more important initiatives, however, would be to take decisive actions to reduce projected budget deficits. Another might be to tax the income from capital more uniformly. The current tax structure taxes different types of capital at very different rates, leading to some misallocation of capital.

Senator Kasten. The Administration has forecast a growth rate of 3.9 percent for the next calendar year. The major forecasting firms have raised their forecasts for 1985 economic growth. Wharton, in fact, forecasts a rate of 4.0 percent --up from their November forecast of 3.5 percent. In light of recent data, do you think that the Administration's estimate for growth is too conservative?

Dr. Penner. No, I don't think so, particularly if one looks at a two-year-horizon. The Administration's forecast is for 3.9 percent growth this year, as you indicate, and 4.0 percent next year (year-over-year). While many forecasters have recently been raising their near-term assessment of growth, the consensus still seems to be somewhere around 3½ percent to 4 percent for this year and 2½ percent to 3½ percent for 1986. The CBO forecast is for 3.5 percent growth this year and 3.2 percent next year.

Written Questions from Senator Chiles to Dr. Penner and the Responses

Senator Chiles. In your testimony, you have pointed out that a one dollar cut in spending or a one dollar increase in taxes lasting for the entire 1985-1990 period implies an interest savings during 1990 of over 70 cents. Using your likely reestimates of the President's budget, we see that the President missed his original targets for deficit reduction by $12 billion in fiscal year 1986, by about $35 billion in fiscal year 1987 and by about $70 billion in fiscal year 1988. Using CBO's methodology, we estimate that failure to meet those targets will cost us more than $14 billion in interest expenses in fiscal year 1990 alone. This is more than we will spend on all natural resources and the environment programs in that year under current baseline projections. Aren't we paying a high price in interest costs for not reducing the deficit faster and more boldly?

Dr. Penner. The costs of not reducing projected current policy deficits—or of delay in taking action—are very high. The importance of taking action is illustrated by the example in my testimony: stabilizing the ratio of debt-to-GNP by 1988 might be attained with program cuts or tax increases of $30 billion in 1986, $55 billion in 1987, and $90 billion in 1988. The interest saving from these policy changes—and the interest cost from not taking them—would grow from $2 billion in 1986 to $25 billion in 1989. Moreover, if market interest rates responded favorably to the plan, the interest saving would be even greater. If these deficit-cutting actions were delayed even one year, interest costs would be $11 billion higher in 1989, and $26 billion higher, cumulatively, over the 1986-1989 period.

Senator Chiles. As your testimony indicates, CBO's economic projections for fiscal year 1987 through fiscal year 1990 are based on long-run historical averages. As such, they do not assume any recession occuring during that time. Under the President's budget, deficits will be about $170 billion during these years. If we were to have a strong recession between now and 1990, what could happen to deficits, debts and interest costs as a result? Even more important, what do we do about fiscal and monetary policy if we go into a recession with deficits of 3 to 5 percent of GNP?

Dr. Penner. Our medium-term economic projections assume that real GNP and labor productivity will grow at rates precisely equal to their average growth in the eight-year periods following earlier postwar recessions. Such periods typically contain at least one recession, and the current projections do not rule out a recession. The projected growth rate has simply been smoothed to reflect average performance.

The CBO low-growth alternative, which assumes a one percentage-point lower annual growth rate from the recession trough at the end of 1982 to the end of 1990 than in the baseline, incorporates a deep recession in 1987. Under this alternative, the budget deficit rises from $232 billion in fiscal year 1986 (5.6 percent of GNP) to $425 billion in fiscal year 1990 (8.7 percent of GNP). By 1990, the government debt would equal approximately 67 percent of GNP, compared with 50 percent for the baseline projection. Interest costs in fiscal year 1990 would be $12 billion higher compared with the baseline.

If we were to experience relatively-low trend growth and go into a severe recession with deficits already above 5 percent of GNP before the recession, fiscal and monetary policies would be placed in a very severe bind. Government debt would be growing extremely rapidly, which could crowd out longer-run investment and would severely add to the longer-run interest costs of servicing the debt. Yet, it would be an especially difficult time to take deficit-reduction measures since they could make the short-run economic situation worse. Moreover, the existence of very large deficits would greatly complicate any attempts to use discretionary fiscal policies to mitigate the recession's impact. With respect to monetary policy, the Federal Reserve might feel highly constrained by the large deficits and therefore keep monetary policy relatively tight. That, in itself, could deepen and prolong the recession.

Senator Chiles. There are those who say that economic growth alone can solve our deficit problem. In your baseline economic and budget projections you show the unemployment rate declining to a level very close to what economists consider full employment. At the same time you show that budget deficits will grow to nearly $300 billion by 1990 unless current policy is changed.

Doesn't this mean that even as we move toward full employment, our deficit problem will not go away but actually get worse? Do you believe we could get to full employment if we let the deficit rise to baseline levels?

Dr. Penner. Our projections are based on an assumption that the unemployment rate can decline gradually to about 6 percent without engendering inflationary pressures within labor markets. Although there is great uncertainty about just how low unemployment can fall without causing inflation to accelerate, our baseline projections imply that as we move toward a noninflationary, full employment range, the deficit in absolute terms will continue to grow and, as a percent of GNP, will remain roughly constant at about 5 percent. The debt-to-GNP ratio, however, would continue to increase rapidly. That would exert upward pressures on interest rates, and the interest cost of servicing the growing debt in relation to GNP would become considerably more burdensome than it is now.

The feasibility of the medium-term economic projections under current policies is highly uncertain. If the very large increases in federal debt cannot be absorbed in the domestic and international capital markets without major increases in interest rates, then the economic outlook would be substantially altered. For instance, a slowing of capital inflows and a precipitous decline in the exchange value of the dollar could put strong upward pressure on inflation and interest rates. While a weaker dollar should help export and import-competing industries, it is very difficult to anticipate the overall impact of these developments on growth.

Senator Chiles. You have given us projections of what the deficit would look like if the economy grew at very rapid rates from now through 1990. These projections show the deficit declining to $126 billion in 1990. But these projections also show that the price of reducing the deficit in this way is an inflation rate that rises to over double our current rate, short-term interest rates that rise to 13.2 percent and long-term corporate interest rates that rise to 15.8 percent.

Given all the pain that we just went through to get inflation down to tolerable levels, and the fact that interest rates are still too high, do you agree that it makes no sense to try to inflate our way out of our deficit problem? Wouldn't those higher interest rates choke off the high growth in our optimistic path?

BACKGROUND--CBO HIGH PATH PROJECTIONS

FY	Deficit	Inflation	T-Bill Rate	AAA Bond Rate
1985	210	3.5%	7.1	11.6
1986	190	4.6	7.7	10.7
1987	181	4.9	8.2	11.1
1988	168	5.9	9.8	12.3
1989	154	7.1	11.4	13.4
1990	126	8.6	13.2	15.3

Dr. Penner. Since the personal income-tax system has been substantially indexed for inflation, inflation no longer does as much to close the budget deficit. For instance, according to CBO's rule-of-thumb calculation, a one-percentage-point higher inflation rate, starting in January 1985, would actually lead to slightly higher deficits if discretionary programs were fully adjusted for inflation. If discretionary spending is not adjusted for inflation, then this increase in inflation would lead to a slightly lower deficit in fiscal year 1986 ($1 billion lower), with the reduction growing to $22 billion by fiscal year 1990. An important assumption behind these results is that an increase in the inflation rate is correspondingly reflected in higher interest rates, which raise the costs of servicing the public debt.

The CBO high-growth path, which assumes considerably faster productivity growth than the baseline, presumes very strong final demands. Inflation rises sharply toward the end of the projection because of real resource constraints. The unemployment rate falls below the level that most economists believe can be sustained without accelerating inflation. In addition, real interest rates rise reflecting strong credit demands.

As your question suggests, the CBO high-growth path implies some longer-run problems after 1990. In particular, bringing down the inflation rate could prove costly, as it was in the first half of the 1980s. At some point, high real interest rates would likely choke off growth, raising the unemployment rate.

Senator Chiles. Mr. Penner, yesterday Budget Director Stockman defended the President's defense budget request by pointing out that the defense budget in fiscal year 1986 is largely the result of the policies the Congress has supported and enacted since 1981--policies that inevitably and understandably drive the defense budget upward. He challenged those who would reduce the defense budget significantly to state clearly which policies they would change. I understand you have seen Mr. Stockman's testimony. I have several questions.

1. Are there any policies that have been enacted since 1981 that you believe are of lower priority, or possibly even counterproductive, in an effective defense strategy for the United States? If so, what are they and what would we save in fiscal 1986 and beyond by removing them?

2. Are there any new policies that we could implement that would make for a better defense effort at lower cost? If so, what are they and what would we save in fiscal 1986 and beyond by implementing them?

Mr. Penner, we all suspect that there are inefficiencies in the Defense Department and that if they were eliminated or reduced, the defense budget could be lower than it is. The real question, however, is how to assume that if Congress reduces the defense budget in the name of greater efficiency, that result will actually occur.

3. In your judgment--and for this purpose let's assume that existing defense policies remain unchanged--is there any likelihood that defense budget reductions will result in greater efficiency? If so, how much do you believe the defense budget could be reduced in fiscal 1986 in the name of greater efficiency alone?

Mr. Penner, there has been talk recently about the possibility of a one-year "standstill" budget for defense. I presume a "standstill" budget means that existing quantities of procurement, operating hours, force levels, etc., are held constant for one year except for upward adjustments in operating budgets that relate to additional weapons coming on line or increases in procurement quantities in cases where long-planned programs are at critical stages of production.

4. Assuming the existing defense policies remain unchanged, can you give us your estimates of defense savings in fiscal 1986 and future years that would occur if we were to adopt a "standstill" budget of the kind I have described? Can you also give us an indication of the downside risks of such a "standstill" approach?

Finally, Mr. Penner, some have suggested that we have a one-year "freeze" on defense budget authority, with overall budget authority for fiscal 1986 held to the same nominal level enacted by the Congress for fiscal 1985.

5. If Congress were to enact such a one-year freeze, can you give us your suggestions on how it should be carried out, including the policies that would have to be changed if any, the impact on defense operations, the risks involved, and the savings that would result in fiscal 1986 and future years?

Dr. Penner. I would like to respond to your questions, Sir, in the order in which you raised them.

1. As director of the Congressional Budget Office, I believe that it is beyond the purview of my office to judge the priority of policies that have been enacted since 1981 in support of our current defense strategy. Should the Congress decide that it can choose a different policy regarding particular weapon systems or particular forces, then we can certainly provide an assessment of the budget implications of such a decision.

2. In volume two of our Annual Report, Reducing the Deficit: Spending and Revenue Options (February 1985), we have offered numerous examples of options that the Congress might choose if it wished to decrease the Defense budget. These range from cancellation of weapons systems to military retirement reform. The saving associated with each option are listed in the volume. The volume also discusses the pros and cons of each option but does not, of course, recommend for or against any particular approach.

3. It is very difficult to assess how much can be attributed to inefficiencies in any budget. Certainly there may exist some inefficiencies in the Defense budget, but a general reduction in defense spending purely on the grounds of believed or perceived inefficiencies may nor result in improved efficiency. Rather if Congress could identify particular inefficiencies and target reductions in a particular area, such as

consolidating military bases or creating a more efficient military pay system, then you may achieve savings while eliminating some inefficiency.

4. During my recent testimony, I agreed to provide the Committee with our assessment of the implications of a budget freeze along the lines specified by Senator Domenici. We plan to examine several strategies for achieving both a nominal freeze and a real freeze in defense budget authority. The concept of a "standstill" budget will be examined in this context.

5. My staff is currently examining the implications of a one-year freeze on defense budget authority in response to Senator Domenici's request. This analysis will be available to the Committee shortly.

VIEWS OF THE FEDERAL RESERVE SYSTEM

FRIDAY, FEBRUARY 8, 1985

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 9:06 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Boschwitz, Quayle, Gorton, Chiles, Johnston, Sasser, and Exon.

Staff present: Stephen Bell, staff director; and Gail Fosler, chief economist.

For the minority: Richard N. Brandon, staff director; and John Hilley, senior economist.

Chairman **DOMENICI**. The hearing will please come to order.

I am going to start now. I know Senator Johnston is here, and I am sure Senator Chiles will arrive shortly. I'm sorry Mr. Chairman, but I have to leave for a few minutes and go downtown to the White House, and I will try to get back as soon as I can.

OPENING STATEMENT OF CHAIRMAN DOMENICI

First of all, I want to thank you for accommodating this early morning hearing and our schedule. I understand, and the Committee has been told in advance that you are testifying here in advance of your meeting with the Federal Open Market Committee next week. we appreciate that, and we understand what that means to you.

We will not question you on future monetary policy. We have already been told what your position is, until you have met with the Board.

BUDGET POLICY

But rather, we would like to discuss your views on Federal budget policy and the Fed's view of its own role in achieving sustained economic stability in this country.

As you know, Mr. Chairman, the President has proposed a significant budget package. I do not know that I agree with his exact mix of spending reductions, but I think the overall goals he set are about right, and clearly, are very difficult to achieve.

I gather—I hope I am not wrong—from your past comments, at least as I have interpreted them, that you may very well agree. However, I think it is important that we not underestimate how difficult it is going to be to get the political consensus we need on specific budget cuts, especially if they are going to be of the size the President has recommended in 1986.

Many talk about an across-the-board freeze in Federal spending, that is, in budget authority, but that is certainly not enough if you are looking for $50 to $54 billion in outlay savings. There will have to be reform and reductions and terminations in a number of programs before we are finished. The rhetoric has simply not caught up with the reality. The freeze notion is assumed to save more than it will when applied in a typical congressional manner of freezing budget authority.

But once we get a reconciliation instruction and hopefully, a bill that would accomplish these goals, I would like to say to you, Mr. Chairman, in all respect, we are going to have to be able to point to a clear result in terms of lower interest rates and lower Federal budget deficits.

FED POLICY CONTRIBUTED TO RECESSION

In this regard, I note that the Economic Report of the President argues that the Fed policy contributed to the length and severity of the recession, that a similar reduction in money growth contributed to a slowdown in the second half of 1984. That slowdown and the corresponding slowdown in inflation cost the Federal budget about $18 billion in revenues, about one-third of which was made up by lower interest costs on the outlay side.

I am not saying that I agree with the report, I am merely stating that that is what the report says. What the Fed does, however, goes directly to the bottom line of the Federal budget. It is inevitable that Murphy's law applies to the Federal budget. But I must say to you today something I have said in the past. We must come to a point in this process when the budget effect of changes in law, legislated by the Congress, are not offset by a volatile economy, and to my mind, an interest rate effect which is keeping interest rates high.

INTEREST RATE RELIEF

I hope you will address the CEA criticism directly in your testimony, Mr. Chairman. You can help us understand better the goals that you believe are prudent for budget policy and what we can hope for in terms of other economic activity and in particular, interest rates.

You have indicated in the past that we might expect interest rates to be a percentage point lower than they would otherwise be if we achieve a deficit reduction package of this size. This appears to me, as one Senator, as hardly enough, but certainly any relief on the interest rate front is welcome.

It is my hope that interest rates will fall dramatically if we take truly dramatic action. We cannot achieve that result unless we are all working together.

It is also my hope that we can achieve more stable growth with low inflation if we bring down the budget deficits. But obviously, your views and your participation and activities will be very important in that regard.

As I said, I will have to leave for a while at 9:20, but we will have Senators here to complete the questioning, after you have had a chance to testify.

Now, I will yield to the distinguished Senator from Florida, Senator Chiles.

Senator **CHILES**. Thank you, Mr. Chairman.

Good morning, Mr. Volcker.

Mr. **VOLCKER**. Good morning.

OPENING STATEMENT OF SENATOR CHILES

Senator **CHILES**. It is always good to have you with us.

We know your views about the importance of deficit reduction. In the past, you have made it clear that $50 billion was the amount we needed just as a downpayment against the deficit. Now that we have the President's budget, I will be interested in your thoughts on whether a true $50 billion reduction this year is really enough to start doing the job right.

LIVING WITH DEFICITS TEMPTING

I know there is a great temptation around these days to say that we can live with these deficits. There seems to be some growing sentiment that if we just manage them, cut a little here and squeeze a little there, that the economy can peacefully coexist with annual deficits of over $150 billion.

In fact, I am beginning to find that some of us, including myself, sort of lose our credibility after a while, and you talk about all of the terrible things that are going to happen if we do not do something, and then they do not happen. The economy seems to be flourishing, the stock market seems to be growing by leaps and bounds, the bond market seems to be growing, interest rates on the short term have even ticked down, and unemployment has come down a little, or held steady. And yet, we still see these high real interest rates.

I think many are beginning to just ask, "Is this just something we did not realize, that you can live with a $200 billion deficit, that you can live with $140 billion trade deficits?"

DEBT SERVICE COST

When I look at the budget, the one thing that jumps out at me as high as the deficit itself is the growing amount of debt service cost. It is growing right now faster than any part of the budget. It threatens to chew up not just many necessary Federal programs, but hope, as well. It seems to me it is bad enough that you have to borrow to pay your bills, but when you are borrowing to pay the interest on the debt, that is usually when we say people are in real trouble, and I think the Government is in real trouble, too.

Our financial problems at home seem to have compounded that situation abroad, as we are faced with a "double deficit". We owe each other $200 billion for this year. But because of this year's record deficit, we owe other nations an additional $100 billion. This borrowing has made the dollar so strong it looks like we are giving the foreign competition up to a 40-percent discount on the international trademarkets. If American goods cost more overseas, and foreign goods cost less, that means that when people shop for bargains, they buy foreign goods. That means American workers are going to have to pay with their jobs.

Maybe that is just another one of those clouds on the horizon people do not want to worry about. But I worry. It seems to me we cannot afford to let our deficits eat up the job prospects for our workers.

This morning, I hope you can give us the most straightforward assessment possible of how much deficit reduction we need this year to get the job done. and I hope you will be just as plainspoken in your appraisal of how these high interest rates are affecting our ability to compete in world markets.

We look forward to your testimony, and we certainly look forward to your help.

Thank you, Mr. Chairman.

Chairman DOMENICI. Senator Johnston.

Senator JOHNSTON. I have no opening statement, Mr. Chairman.

Chairman DOMENICI. Thank you. At this time, without objection, I would like to insert in the record a statement from Senator Hatch who is unable to be here today.

[The statement of Senator Hatch follows:]

STATEMENT OF SENATOR HATCH

Thank you, Mr. Chairman.

Let me welcome Chairman Volcker and state that while I am still concerned about the erratic nature of money growth rates, it is good to see lower longer run growth rates for the money supply that we had 2 years ago. Interest rates are declining and inflation is still at a relatively low level. Despite calls of several of my colleagues for more rapid growth, I join in supporting what appears to be the Fed's policy of slowing dropping M1 growth rates from their high of 13 percent in 1983 to their currently more moderate levels. I am hopeful that this trend continues downward until the growth rate once again coincides with noninflationary trends. I do think that, if there were a politically good time to move toward zero inflation in monetary policy, it is now while the economy is healthy and interests rates are declining.

Chairman DOMENICI. Mr. Chairman, we welcome you.

STATEMENT OF PAUL A. VOLCKER, CHAIRMAN, BOARD OF GOVERNORS, FEDERAL RESERVE SYSTEM

Mr. VOLCKER. Well, thank you. I hardly know where to begin, after all those questions.

I have a short statement, which summarizes some of the comments I made earlier this week to the Joint Economic Committee, which I will submit for the record.

Chairman DOMENICI. It will be made part of the record at the conclusion of your opening remarks.[1]

FLAWS, IMBALANCES, AND DISEQUILIBRIUM IN PRESENT SITUATION

Mr. VOLCKER. The principal point that is made there is that while the economy is doing well in an overall sense, while the outlook appears favorable at the moment, while I think we have a great opportunity to lay the base for a long, sustained expansion, I think there are also great flaws and imbalances and disequilibrium in the present situation. It goes to Senator Chiles point—what is the matter? Clearly, something is the matter when we are running a trade deficit of $110 to $120 billion a year, when we are borrowing $100 billion abroad—when and we have to borrow $100 billion abroad—to balance our domestic capital markets accounts, because we are investing more at home and we are borrowing more for the Federal Government than we can possibly save, so we have to borrow it abroad. When we borrow it abroad, the necessary consequence is we have a big trade deficit. And if you think a trade deficit of that size is sustainable and does not cost us anything, maybe you can be happy with the situation. But I think it is not sustainable and does cost us over time. We have to pay interest to foreigners on it. I think it is an inhibition on foreign growth which comes back and hurts us. I think, in the end, it is not sustainable, and if we are not prepared to clear away some of this internal budget deficit, then when that day comes when we cannot count on so much savings from abroad, we will be in trouble at home.

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[1] See p. 175.

HUGE DEFICITS POSE THREAT TO ECONOMIC GROWTH

I picked up a forecast yesterday, a rather elaborate set of forecasts from a private forecasting service. They made some comments that I thought were so relevant to what I am saying, it might be worthwhile quoting some of it to you.

They have a standard forecast of rather moderate growth next year, some progress on inflation, but rising interest rates. That is their standard forecast. And what they say about it is:

> Huge Federal budget deficits pose the greatest threat to sustained economic growth. Treasury refinancing has posed little problem in the credit markets recently, because private sector borrowing has been weak. However, we project interest rates to climb by 100 basis points by the fall of 1985, as Treasury refinancing requirements begin to clash with stronger consumer borrowing and still healthy capital spending. Indeed, the better the outlook for the economy as a whole in 1985, the greater the likelihood of a credit crunch. The collision of public and private credit demands will most assuredly temper growth by late this year and slow the expansion well into 1986.
>
> A long-term side effect of persistently high deficits is the growing expense of servicing the accumulated debt. Very shortly, the growth of this component of the Federal budget could become unstoppable. The position of the Federal Government today is much like that of a homeowner who takes out a second mortgage, then a third mortgage to pay the interest on the second, and then a fourth to cover that interest, and so on. The forecast assumes that prompt spending cuts are unlikely.
>
> Despite the flurry of optimism last month about cuts in Federal outlays, most of this will turn out to be vacation talk. Even after correcting for business cycle influences, the structural deficit is expected to remain at 4.2 percent, at full employment GNP, forcing interest rates up while absorbing 24 percent of new savings.
>
> The general effects on the economy are clear, even if the timing is not. Although real growth will vary around a moderate trend, the deficits will force interest rates upwards as private credit demands increase. The exceptionally high interest rates will depress private investment, weaken manufacturing competitiveness, and expand our overseas debt burden.

OPTIMISTIC SCENARIO

That is one view. Then, they give an optimistic scenario. They say:

In the optimistic scenario, inflationary expectations continue to decline, bringing interest rates down. Although the dollar declines as well, profit margins and wage settlements remain modest, keeping inflation lower than expected in the standard forecast.

Real GNP rises more strongly through the period, but the lower inflation allows the Federal Reserve to keep its monetary targets. The stronger economic growth and larger expenditure cuts reduce the Federal deficit to half by the end of 1987. It is almost in the power of our elected representatives and our central banks to achieve this scenario, but major political compromises are required.

They are setting out the contrast that they see between action—strong action—on the budget deficit now, and no action. Whether or not I would agree with all the details, I think this is one way of putting the challenge that you have before you.

Chairman DOMENICI. Thank you very much.

[The prepared statements of Mr. Volcker follow:]

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Senate Budget Committee

February 8, 1985

I am pleased to appear once again before this Committee to discuss the economic situation, and in that context some implications of the budgetary choices you must make for the economy, for financial markets, and for our international position. I realize the task that confronts you in dealing with the budgetary position is extremely difficult. Those difficulties are matched by their significance for the well-being of our economy and, indeed, of the world economy generally.

Earlier this week I testified before the Joint Economic Committee. That testimony reviewed our economic progress, the obstacles and risks before us, and attempted to place questions of monetary and fiscal policy in that setting. I have submitted copies of that statement to the Committee and will not repeat it this morning.

Suffice it to say that the past two years have demonstrated highly encouraging progress toward returning the economy to a path of sustained growth and stability. Most observers concur that the immediate prospects remain favorable. But at the same time there are large imbalances in our economic performance and points of severe strain here and abroad. There are particular factors helping to account for many of those strains, and they must be dealt with directly. But it is also true that most of those specific difficulties are reflected in and aggravated by our twin deficits -- in our budget and in our external trading accounts. Those two deficits are themselves related to each other.

Until those underlying problems are adequately addressed, we will be putting at risk our hard-won gains and the bright promise for the future. It is difficult for me to see a constructive solution to those problems without going to their source. The implication seems to me clear -- we need to deal effectively with the reality of an enormous budget deficit at a time of growing prosperity and with the clear threat that, left untended, that deficit will rise over future years even in the context of a growing economy.

As background for your deliberations, I would emphasize the linkage of our budgetary posture to the external side of the economy. The simple fact is we can no longer view our economy in isolation from the rest of the world. As you know, the imbalances in our economy are most obviously manifested in our massive trade and current account deficits, which reached about $110 billion and $100 billion, respectively, during 1984. It is not a coincidence that these external deficits have developed alongside the internal budget deficit.

That budget deficit, together with the rising investment needed to support growth and productivity must be financed either internally or externally. We do not have the capacity now or prospectively, given the size of the federal deficit, to save enough domestically to meet those needs. We have become perforce dependent on a growing net inflow of foreign savings to supplement our own.

The two tables attached to my statement illustrate the point. Even as domestic savings have grown, about one-quarter of our net needs for investment and for deficit financing have had to be met from foreign sources. So far, that capital has been readily available, partly because more new funds have poured in from abroad and partly because our banks are lending less to other countries. That flow has had the effect of containing pressures on interest rates and on our capital markets, even though interest rates, as you know, have remained high historically and relative to the current rate of inflation.

But the implications of that capital inflow are not all favorable, and the adverse implications are mounting. The mirror image of a capital inflow is the trade and current account deficits, with adverse impacts on all those industries that look to export markets or that compete with imports. One effect is sizable sectors of the American economy have not participated at all fully in the recovery. The drain on foreign savings and the related depreciation of their currencies vis-a-vis the dollar, seem to be inhibiting prospects for internally generated growth abroad. At the same time, our capital markets and interest rates have become hostage to a continuing flow of foreign capital. Over time, the interest cost of those foreign borrowings will compound upon themselves.

A basic objective of monetary policy is, of course, to provide enough money to sustain growth in domestic demand in a framework of moving toward greater price stability. Sometimes the suggestion is made that we can go further and somehow resolve the imbalance between domestic savings and investment by expanding the money supply. But printing money is not a substitute for the real savings necessary to finance high levels of investment and budget deficits simultaneously. Excessive money creation would be counterproductive in two respects. To the extent it stirred new inflationary fears, after all the progress that has been made, those fears would sustain the level of interest rates and even drive them higher. By undermining the growing confidence in prospects for stability, it could discourage the capital inflow on which, for the time being, we are dependent.

The Federal Reserve, the Administration and the Congress have no magic wands to restore equilibrium and to assure growth in one easy stroke. Efforts must be made in a number of directions to sustain the bright promise of the economy. But the key ingredient in the policy mix seems clear enough. Steps now toward decisive, creditable reductions in our budget deficits -- large enough to have an impact on expectations and confidence in markets -- would provide the necessary sense of reassurance while working to alleviate the underlying imbalance between our capacity to save and the demands on those resources.

I am sensitive to the difficult, practical and political decisions that must be made. But I also know the longer the choices are delayed, the greater the risks and the larger the task. As we saw in the 1970's, confidence can be a fragile thing. It needs to be nourished and defended.

It will take action, and strong action, to get the deficit on a downward trend. Then growth can help to do the rest. And your action on the budget will help enormously in assuring that growth can be sustained in a framework of greater price stability.

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TABLE 1

DEMANDS ON NET SAVING AND SOURCES OF NET SAVING
(Percent of gross national product)

		Demands on net saving		Sources of net saving	
	Total	Net private investment[1]	Federal budget deficit[2]	Domestic[3]	Foreign[4]
1974	7.0	6.2	0.8	7.2	-0.2
1975	7.1	2.7	4.5	8.3	-1.2
1976	7.6	4.5	3.1	7.9	-0.3
1977	9.0	6.6	2.4	8.3	0.7
1978	9.1	7.7	1.4	8.4	0.7
1979	7.6	7.0	0.7	7.6	0.1
1980	6.4	4.0	2.3	6.6	-0.2
1981	7.2	5.0	2.2	7.4	-0.2
1982	6.7	1.8	4.8	6.5	0.2
1983	8.2	2.8	5.4	7.2	1.0
1984(p)	11.4	6.6	4.8	8.9	2.6

p = preliminary

[1] Net private investment is the sum of business fixed investment, residential construction outlays, and the change in business inventories, less depreciation, minus a statistical discrepancy.

[2] NIA basis.

[3] Domestic net saving includes personal saving, undistributed corporate profits, and state and local government surplus.

[4] Equals payments to foreigners for imports of goods and services, transfer payments, and interest paid by government to foreigners minus receipts from foreigners for exports of goods and services.

Note: These figures exclude depreciation, which amounted to $403 billion in 1984; including depreciation would raise both domestic investment and domestic saving.

Source: Calculations based on data from the National Income and Product Accounts.

TABLE 2

DEMANDS ON NET SAVING AND SOURCES OF NET SAVING
(Billions of dollars)

		Demands on net saving		Sources of net saving	
	Total	Net private investment[1]	Federal budget deficit[2]	Domestic[3]	Foreign[4]
1974	100.4	88.9	11.5	103.3	-2.9
1975	110.6	41.3	69.3	128.8	-18.3
1976	130.8	77.7	53.1	135.9	-5.1
1977	173.4	127.5	45.9	159.7	13.6
1978	196.1	166.7	29.5	181.8	14.3
1979	184.6	168.5	16.1	182.8	1.8
1980	167.7	106.4	61.2	174.0	-6.3
1981	212.6	148.3	64.3	218.4	-5.8
1982	204.6	56.5	148.2	198.1	6.6
1983	272.6	94.0	178.6	238.7	33.9
1984(p)	419.0	242.6	176.4	324.5	94.5

p = preliminary
See table 1 for footnotes.

Statement by

Paul A. Volcker

Chairman, Board of Governors of the Federal Reserve System

before the

Joint Economic Committee

February 5, 1985

I am pleased to appear once again before this Committee to discuss the economic situation. As you know, the Federal Reserve will be submitting its semi-annual report on monetary policy to the Congress in about two weeks. My testimony then will provide a full account of recent monetary developments and will report on the decisions to be taken shortly by the Federal Open Market Committee regarding money and credit targets for 1985. Therefore, in my prepared remarks this morning, I will limit myself to a broader view of the current economic setting, with some emphasis on the interrelationships between domestic and international developments.

Two years ago, when the current business expansion was just beginning, I expressed to this committee my belief that, through a difficult period of economic and financial adjustment, we had potentially been laying the groundwork for sustained growth and prosperity. I felt then, and I feel now, that restoring and maintaining a greater sense of price stability would be central to that effort.

Today, I think it is fair to say that bright promise for the longer run remains. Economic growth has in fact been strong over the past two years, and inflation has remained at or very close to the much lower levels reached at the start of the recovery period. As 1985 started, most observers have shared the view that prospects for further growth remain good, and expectations of stronger inflationary pressures as the expansion period is extended, quite prevalent earlier, have been at the least muted.

Nonetheless, clear risks and obstacles remain to making good on our own potential both for stability and growth, and to accomplishing that, as we must, in the context of a more prosperous world. To a considerable degree, the "buts" and "ifs" are well understood. Yet, that intellectual understanding will be for naught if the appropriate policy responses are lacking, whether because of unwarranted complacency bred by current performance, because of the inherent political difficulty of reaching the necessary consensus, or because of some combination of the two.

The Evidence of Progress

The clearest evidence of progress toward our long-run aims lies in the combination of better than anticipated growth and lower than anticipated inflation over the past two years. To be sure, the current expansion began from a low level, and unemployment has not yet been reduced to levels we have enjoyed historically and want to regain. But after widespread doubts about our economic prospects, the recovery of 1983 has blossomed into what has been one of the strongest expansions of the postwar period.

Real gross national product grew more than 5-1/2 percent over the course of 1984, bringing the cumulative gain in domestic output over the past two years to about 12 percent. The rise in production has been associated with an increase in employment of more than 7 million since the end of 1982, and the unemployment rate has fallen about 3-1/2 percentage points over that period, to around 7-1/4 percent. As part of that general improvement, there has been a sharp rebound in profits and a surge in business investment, factors that should bode well for our future growth potential. Spending for innovative, high-technology capital has grown especially rapidly. Productivity has grown more strongly, although there are still important questions as to how much the underlying trend has improved.

The recent monthly data on consumer and producer prices continue to show only very small increases for a wide range of goods. For some important commodities, including petroleum and a number of raw materials, price declines have been more common than price increases. Prices of most services have continued to increase at a substantially more rapid rate -- averaging 5 to 6 percent at the consumer level. Most of our economy today is, in fact, a "service" economy. Those services are generally subject less directly to competitive pressures from overseas. Moreover, labor intensive sectors of the economy, such as many services, may have less opportunity for productivity growth. Nevertheless, the rate of price increase for services has been significantly less than in the late 1970's and the first years of the 1980's.

Further improvement will be necessary in these areas to maintain progess toward stability. In a direct sense, that depends in considerable part on whether the rate of nominal wage increases continues to decline in service industries to levels more characteristic of the rest of the economy.

With inflation down, workers generally have apparently felt less need to press for large increases to make up for past price increases or to stay ahead of expected inflation. Businessmen and workers in manufacturing, mining, and construction have also recognized that they often operate in a more competitive and more international environment -- one in which there are obvious perils in rising costs and prices and a premium on efficiency. The restraint on wages and costs generally need not mean, however, reduced prospects for gains in real income. To the contrary, the "payoff" in a growing economy, with rising productivity and more stable prices, is more jobs and higher real incomes for the average worker.

Success in containing inflation can help to breed further success. It is indispensable to prospects for achieving and maintaining a lower level of interest rates, which, despite declines in recent months, have remained historically high. Over time, expectations of greater price stability should become increasingly woven into the fabric of household, business, and financial decision-making. Efficiency and productivity should benefit as less energy is spent in the largely futile search for ways to "beat" inflation. Pressures for "precautionary" wage and price increases have diminished. As borrowing and lending horizons are lengthened, the financial structure should be strengthened, and less "inflation insurance" will be built into long-term interest rates.

Obstacles and Risks

After all the disappointments of the past with failed anti-inflationary efforts, that process inevitably takes time. Meanwhile, we cannot simply assume that inflation has been conquered, or that we have in fact reached a new era of sustained growth. There are still too many obstacles to permit that kind of satisfaction.

To put it bluntly, there are large and unsustainable imbalances in our economy, and in the world economy. In the midst of the overall improvement that I cited earlier, those imbalances are reflected, for instance, in the intensity of the strains in agriculture and in a number of other basic industries. There have been exceptionally high levels of unemployment in many other industrialized countries, and, looking ahead, too few signs of really significant improvement in that respect. That outlook bears on our own markets. Moreover, the financial position of the heavily indebted developing countries remains vulnerable, and their difficulties can feed back on our economic outlook and financial system. And, as I noted earlier, interest rates remain high relative both to historical experience and to recent rates of inflation.

These difficulties arise in part out of structural problems unique to one sector or another, and to that extent must be addressed at that level. The painful pressures on some businesses, farms and financial institutions also reflect the strain of adjusting to a less inflationary environment, when their financial decisions had, implicitly or explicitly, been based on expectations of accelerating inflation. But these strains are being aggravated by financial pressures and dislocations related to our budgetary problems. Until that underlying problem is dealt with appropriately, we will unnecessarily be putting at risk all those bright prospects for stability and growth of which I have spoken.

The distortions in the economy are manifest in our massive trade and overall current account deficits, which reached levels of almost $110 billion and $100 billion, respectively, during 1984. It is not a coincidence that those external deficits are accompanied by an enormous internal budget deficit -- a deficit that, according to both Administration and Congressional Budget Office estimates, will tend to grow further in the absence of corrective action even assuming healthy economic growth.

Given the deep recession and high levels of unemployment in 1982, the sluggishness of the world economy, and the strains on developing countries, sizable deficits in our budget and trade accounts could and did serve an important transitional function in helping to encourage recovery here and abroad. Specifically, the domestic deficit helped sustain and increase domestic purchasing power, and the more favorable tax treatment for investment helped encourage capital spending. The growth of our markets has probably been the single greatest expansionary force for other countries over the past two years, and our economy absorbed the brunt of the necessary efforts of the heavily indebted Latin American countries to restore external financial and economic equilibrium.

At the same time, the strength of the dollar in the exchange markets, together with the ready availability of goods from abroad, have been potent factors in damping inflationary forces and satisfying our consumption demands.

What then, it might be asked, is the difficulty? Why not rest content?

The answer, most fundamentally, is that economic analysis and common sense coincide in telling us that the budgetary and trade deficits of the magnitude we are running at a time of growing prosperity are simply unsustainable indefinitely. They imply a dependence on growing foreign borrowing by the United States that, left unchecked, would sooner or later undermine the confidence in our economy essential to a strong currency and prospects for lower interest rates. At the same time, the hard fact is that the budget deficit, on top of the private investment needed to support growth and productivity, outruns our internal savings potential. The largest and richest economy in the world has perforce been required for the time being to draw on savings generated abroad; in that real sense we are living beyond our means. As we continue to draw so heavily on the world's savings, there is a drag on internally generated expansion elsewhere, feeding back on our trading prospects. And, the resulting imbalances and financial strains generate political pressures, here and abroad, for counter-productive protectionism, for economic nationalism, and for excessive money creation that would, if implemented, undercut and jeopardize all the progress we have made.

The External Dimension

While much of our rhetoric still skirts the issue, the time has passed when we can intelligently assess our performance and our policies without considering the external dimension -- the implications for international trade and capital flows, exchange rates, and economic and financial conditions elsewhere. Like it or not, world financial markets and economies are integrated as never before. Over time, I believe, we derive enormous benefits from that fact. But it imposes disciplines of its own.

The complications in analysis and the potential for good or ill were amply illustrated in 1984. As you know, the growth of economic activity slowed abruptly during the summer and early fall. Following the exceptionally rapid growth over the first half of the year, some slowdown should not have been surprising, given the fluctuations in consumption and inventory imbalances common as an expansion period is extended. By year end, there was evidence once again of more positive trends in household spending and some inventory imbalances appeared to be at least partially corrected.

But as domestic demands slowed, the more fundamental imbalances remained and became more obvious. Throughout this recovery, domestic purchases of goods and services have increased faster than domestic production. In essence, a lot of demand generated in this country has flowed abroad through our rising trade deficit, providing stimulus for production overseas rather than in this country. The increase in imports didn't seem to matter much so long as output and employment generally were expanding so rapidly. But, even then important sectors of the economy, in a real sense, did not share at all fully in the overall recovery, with trade pressures aggravating deep-seated structural problems. As soon as domestic demand dropped from the extraordinarily rapid rate of the first half of the year, the effects of the demand slowdown on production were amplified by the rising trade deficit.

From 1982 to the second half of 1984, the current account deteriorated by about $100 billion, pushing us into an external deficit equivalent to 2-1/2 to 3 percent of the GNP. Just as for a household or business, current spending abroad can exceed current income only to the extent that we can draw on foreign assets or debt is increased. As a consequence, the United States is in the process of moving from the world's largest creditor to the world's largest debtor.

Thus far in the expansion, the net inflow of capital needed to finance the current account deficit has been readily forthcoming, so much so that the dollar exchange rate has persistently strengthened even as the U.S. current account has deteriorated. No single factor appears to account for that flow. Relatively high interest rates in this country, our success in reducing inflation, and perceptions of political stability and economic vitality all have contributed. But political and economic uncertainties abroad appear to have played a part as well.

The strong flow of funds from abroad has been a key factor helping to ameliorate financial stresses in this country, as expansion generated large new demands for private financing on top of the continuing Federal deficit. Two tables attached to my statement illustrate the point.

As indicated there, net domestic savings -- personal, business, and state and local government -- have increased appreciably as the economy has expanded. The ratio of net savings to the GNP is near the top of its historical range. But those domestic savings have not been nearly enough to finance both rising private investment and the Federal deficit. Those requirements, relative to the gross national product, have risen about 4-3/4 percentage points in the past two years to about 11-1/2 percent of the GNP. far above past relationships. About half of that increase was met by higher savings from abroad.

I don't believe we can escape the conclusion that, without the ready availability of savings from the rest of the world, pressures on our financial markets would have been greater and domestic interest rates would have been still higher, at some point undermining the outlook for domestic housing and investment.

The kind of obvious "crowding out," so widely anticipated a year or two ago, has been avoided. But, in a real sense, important sectors of our economy are paying the price. Those dependent on foreign markets and those competing with imports are being "crowded." To put the point in perspective, the $100 billion deterioration in our current account -- a measure of "lost" markets for U.S. producers -- is equivalent in size to about two-thirds of the entire residential housing sector.

As I emphasized earlier, viewed in a world context, our ability and willingness to run a sizable trade and current account deficit during a period of strong domestic recovery had constructive implications for others. But, as we look ahead, neither we nor other countries can expect growth to be maintained indefinitely on a shaky foundation of large and growing trade deficits, massive capital flows to the United States, and accelerating international indebtedness.

The visible strains in some sectors of our economy and interest rates that have remained historically high are clear warning signals. Perhaps less obvious but nonetheless real, the drain of savings from other countries to the United States and the related tendency for their currencies to depreciate vis-a-vis the dollar, appear to be inhibiting more forceful policies to encourage "home grown" expansion abroad. A healthy world economy -- and better export markets for the United States -- are ultimately dependent on that expansion. The dilemma is that so long as demands on our own capital markets exceed our capacity to save, the stability of our own financial markets is, in effect, hostage to a large continuing inflow of foreign capital.

That flow, in turn, is dependent on the maintenance of confidence in our own prospects and in our own currency. But so long as the imbalance in our trade persists and increases, the greater the risk that that confidence will be eroded, disturbing our financial markets and jeopardizing our growth. It is that apparent inconsistency that must be confronted.

The Role of Monetary Policy

While I will be testifying with respect to Federal Reserve policy in some detail shortly, a few general observations about monetary policy are appropriate in this context. That policy, in most general terms, is directed toward encouraging the process of restoring price stability while providing enough money to support sustainable growth in demand and output. Reasonable progress in those directions was made in

1984. Indeed, the strength of the dollar, despite the larger current account deficit, helped to reconcile strong growth in demand over the year as a whole with restraint on prices. But, as I indicated a few moments ago, the rising trade deficit, as more of the domestically generated demand spilled over abroad, clearly raises questions of the sustainability of a process dependent on large inflows of capital.

Monetary policy can stimulate growth in the money supply, but it cannot create the real savings necesary to finance high levels of investment and excessive budget deficits simultaneously. That depends upon all the factors inducing individuals and businesses to save for the future. Efforts to, in effect, paper over the difficulty by financing the huge budget deficit by excessive money creation would surely be counterproductive. We would undermine the growing confidence in prospects for stability. That confidence is a necessary ingredient in any effort to see lower interest rates in the years ahead. It is also essential to maintain the flow of capital from abroad upon which we are for the time being dependent.

In sum, I see no realistic escape from our dilemma by reverting to inflationary monetary policies. They could only accelerate the disturbances we want to avoid. Indeed, without action on the budget and other fronts, the possibility of a reduced flow of capital from abroad would, if it materialized, constrict the flexibility of monetary policy.

The Protectionist "Solution"

The current trade imbalances and the strong pressures on particular economic sectors certainly lead to strong pressures for protection from affected industries. But that approach toward "relief" is symptomatic, not fundamental. Indeed, yielding to those pressures could only aggravate the difficulties, so long as the underlying financial imbalances persist.

Suppose, for instance, strong protectionist measures actually had a pronounced effect in closing our trade deficit. Then, the capital inflow from abroad would also be reduced, and interest rate and inflationary pressures increased. The benefits to one industry would be offset by greater financial market pressures and damage to others. Or, if the capital inflows were maintained the dollar would presumably be driven still higher, shifting the burden to exporters and unprotected industries.

More realistically, protectionism here would be matched, or more than matched, abroad, with devastating consequences for world trade and growth.

A Constructive Approach

One lesson of our experience seems clear. The progress that has been made toward greater efficiency, cost restraint and innovation needs to be continued and encouraged by public policy in a variety of ways rather than discouraged by a retreat into protectionism or new permanent Federal subsidies that distort the economy and aggravate the deficit.

I do not want to suggest all the burden of sustaining a favorable economic climate and restoring external equilibrium rests on the United States. A number of industrialized countries might reasonably review their own possibilities for stimulus in the light of their high levels of unemployment and rather sluggish growth, and they could constructively work to remove the structural impediments to their growth. There is too much protection of markets abroad, and the efforts to deal with that need to be maintained.

There is no single "magic pill" to restore equilibrium and assure growth. But neither can there be real doubt that it is within our capacity to take a large step, here and now, to ease the necessary adjustments in agriculture and industry at home, to make us less dependent on foreign savings, to improve trade prospects, and thus to reinforce prospects for growth and stability. That step would be to make decisive reductions in our budget deficit. Those reductions, to be credible, should be large enough and assured enough to have an impact on expectations and confidence, even if they cannot be fully effective for some time.

That is, of course, by now a familiar plea -- but it is no less urgent for its familiarity. To the contrary, the sharply increased size of our external deficit, the tendency for the budget deficit to grow even as the economy expands strongly, and the still high interest rates, should be warning enough that we are on an ultimately unsustainable path.

Deficits that are relatively benign in the depths of recession or in the early stages of recovery turn destructive at a time of relative prosperity. They are reflected in imbalances in our own economy. At the same time, our dependence on foreign savings can only impede the prospects for self-sustaining growth abroad -- and we cannot indefinitely be virtually the only engine for world expansion.

Action now, and action large and forceful enough to be seen to be decisive, is the constructive way to resolve the impasse and to work toward international balance. In the process, it will help enormously to ensure those bright prospects for growth and stability of which I spoke at the start.

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CREDIBLE REDUCTION URGENT

Chairman DOMENICI. Mr. Chairman, with all of the good economic news being reported, this Senator feels that it is almost impossible to get people to pay attention to the sacrifice and difficult choices that we are going to have to make to reduce the deficit. Yet I understand if we do not move to reduce to deficit during good times, we may have a surge of bad times. We are in one of those situations where the deficit will get absolutely unbearable.

Might I ask you whether you think it is urgent that we make every effort to put together a credible, major deficit reduction package in the nature of $50 billion in real savings in 1986?

Mr. VOLCKER. I do think it is urgent, for reasons I have already implied. I think this is the time to do it, when the economy has had a substantial increase in activity, we have had a reduction in unemployment. These deficits get more and more serious as the economy grows; as indicated, the threat, in a perverse kind of way, becomes greater the more economic growth you have, because the more room you then need for business investment and for housing. We haven't got that room now. We have got severe imbalances in the economy. We have got to begin dealing with them. We have got many good things going on. But I think the greatest single action we can take is to assure that the good continues, and we deal with the threats by aggressive action on the budget deficit now. In my judgment, the time is already late, but we still have time, and we need decisive action now. Any action you take on the spending side is not going to be effective for, let us say, roughly a year in any full way. But by taking decisive action, by enacting it, you begin getting, hopefully, favorable effects and expectations on the climate of opinion. That takes credible action; it takes action, I think, that will not only be effective in the next fiscal year, but will accumulate in subsequent fiscal years, to get that deficit on a declining trend. It is the structural deficit that concerns me. I think all projections are uncertain, but all these projections—OMB, CBO, private projections, Federal Reserve projections—say that the structural deficit is rising, and I think that is what you have to get on a downward trend.

Chairman DOMENICI. Thank you very much, Mr. Chairman.

[Whereupon, Senator Gorton assumed the Chair.]

GROWING OUT OF DEFICIT NOT POSSIBLE

Senator GORTON. Mr. Chairman, our Committee Chairman had to leave. He asked me to follow up your answer by asking you whether you felt it was possible simply to "grow" our way out of this deficit.

Mr. VOLCKER. I think my previous comment said "No" to that question. I think you can take favorable economic projections, extend them over a period of years ahead, but as I understand the spending side of the picture—upon which I am not expert—and accepting the projections of the administration or the CBO, I do not see the possibility of simply growing out of deficit.

The danger is that the deficit will cumulate on itself, even in those conditions, because when the deficits are this size, the interest on the previous year's deficit makes this challenge even greater with each year that you move ahead.

Senator GORTON. Thank you.

I have some more questions, but I will defer now to my distinguished colleague, the Senator from Florida, Senator CHILES.

Senator CHILES. I yield to Senator Johnston.

Senator GORTON. All right. The Senator from Louisiana.

ECONOMY WITHOUT PRECEDENT

Senator JOHNSTON. Thank you, Mr. Chairman.

Mr. Volcker, I have decreasing confidence in my own ability to assay what this economy is all about, because it seems to me that this economy is really without precedent. I cannot ever recall—I am not as keen a student of economic history as you are—but I cannot recall a situation where we have had budget deficits of this size, this relative size compared to the GNP, a trade deficit of this size, foreign borrowing of this size, or another time when we had such growing GNP when basic commodities—metals, agriculture, those heavy sectors of our industrial sector—have been down, this leads me to believe that maybe we are in some kind of new economy. And I almost think maybe we have repealed the budget cycle.

Now, I know that is not so. Would you tell me why that is not so, and what is new and what is not new about this economy?

Mr. VOLCKER. I think you have made two different points in your statement. First of all, you express some surprise as to how we can hang together with a large budget deficit, a large trade deficit—what is going on here—and still have a good, rising economy with prices under control.

I think you can only reconcile those seeming discrepancies by putting another factor into the equation. There is a high degree of confidence in the American economy right now, particularly relative to other countries that have difficulties of their own, and for good reason. We have made some real progress against inflation. I think that kind of stands out as number one. We have got strong incentives for business investment. Business investment on the whole has been doing well. And one could set forth other reasons for this confidence. When that confidence holds, particularly given the problems abroad, we are able to reconcile the domestic imbalance in our financial markets by drawing on all these foreign savings. But we do that at the expense of that big trade deficit, which depresses some areas of the economy—the heavy industry sectors; agriculture, commodity prices, in part.

Now, I do not know how long we can go on this way, but it would seem to be flawed. Can we build up our external debts forever? I doubt it. And as soon as that confidence is impaired, as it inevitably will be someday if these deficits remain that large, then, in my judgment, all the internal inconsistencies are going to come back and make life very difficult for us.

How are we going to finance this deficit if we do not have a big inflow of capital from abroad, for instance?

CONFIDENCE CAN BE A FRAGILE THING

Senator JOHNSTON. Well, that leads me, really, to my second question which was, on page 7 of your statement,[1] you say "* * * confidence can be a fragile thing." And it does seem to me that we are building confidence upon confidence, and this whole economy has a psychological underpinning, which I guess all markets always do, but this one has it to an extraordinary degree. And when and if that confidence begins to erode—when the bubble begins to be pricked—it might burst all at one time.

Now, this really concerns me, because of the, as you described it, internal inconsistencies of this economy.

Another phenomenon that I have observed is that on the stock market, for example, when everyone begins to think the same way, whether it is up or down, the opposite usually begins to happen.

Now, almost everybody, except an occasional doomsayer such as you read—and even he has an obverse side——

Mr. VOLCKER. He was not a doomsayer. He was projecting moderate growth, anyway.

Senator JOHNSTON. At least, those who are predicting the "bust" coming soon are in the decided minority. It worries me that we have got this cycle of boom built upon psychology where everyone is thinking positive.

Is there not really a good chance at this time that if we do not deal with this budget deficit in a very credible way—as to which I have great doubts, frankly—that the whole thing could come unravelled rather quickly?

DELAYING ACTION RISKY TO ECONOMY

Mr. VOLCKER. At some point—I do not know when—I just think you are taking an unnecessary chance, an unnecessary risk to the economy by delaying action. You are clearly taking an unnecessary risk, in my judgment, in the times that we were just talking about. You are also making things more difficult for yourself, in my judgment, in the future, because today's deficit does compound into the future, and the longer the delay in dealing with the deficit, the less adequate the $50 billion—or upwards of $50 billion—that I have cited today is going to be.

Senator JOHNSTON. How much time do we have where we have a high degree of assurance of relatively good performance in the economy where we do not come unraveled?

Mr. VOLCKER. We have a lot of things going for us, and I hope we have a fair period of time, but I frankly do not know.

Senator JOHNSTON. I mean, surely, we know it will not come unravelled in the next month. Can we say 6 months? Or 1 year?

Mr. VOLCKER. I think the prospects look pretty good. Certainly, if you look at the exchange markets recently, I do not see any signs of declining confidence. But I do know the lesson of history, as you yourself suggested, that these things can change quickly and unpredictably.

Senator JOHNSTON. Thank you, Mr. Volcker.

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[1] See p. 172.

POSSIBLE UPSIDE AND DOWNSIDE

Senator GORTON. Mr. Chairman, I would like to oo back to the private newsletter from which you quoted the possible upside if things go right and the possible downside if things go wrong.

I am not sure that I heard, or registered, every, single nuance in that set of predictions. But is it correct to assume that the two predictions had as variables only the degree to which the Congress did or did not act responsibly with respect to the judgment and the judgments which you, heading the Federal Reserve Board, may or may not make with respect to monetary policy?

Mr. VOLCKER. As I understand these two predictions, the only difference in their policy assumption was the budget. They were probably shading assumptions as to prices, one view took a more optimistic view, I think, wage and price developments, as I quickly read this. I think the only policy difference between those two projections is what you gentlemen do on the budget.

Senator GORTON. Is it your view that only our work on the budget and your own on the Board are the principal, if not the sole variables, with respect to those predicted scenarios?

Mr. VOLCKER. No. We had a lot of particular problems in the economy. You have problems with tax reform, you have got agricultural problems now, all of which require attention, and how they are handled will make a difference.

But when you talk about the major decisions before us, what can affect the general course of the economy, the general behavior of the economy—not just in 1985, but setting a pattern for subsequent years— the major determinants that are under our immediate control are budgetary policy, and of course, our responsibilities for monetary policy.

Senator GORTON. And without asking you to predict monetary policy, your monetary policy will certainly be significantly impacted by what we do with respect to budget deficits, I take it.

Mr. VOLCKER. I would like to think our monetary policy will always be appropriate. But you will make the job of monetary policy much easier—that is the implication of some of this contrast here.

We are dealing with monetary policy in a setting now where the demands on our capital markets are far in excess of the supply of savings in the American economy. That is not a very comfortable position for monetary policy to be in, because it implies a combination of persistent pressures on interest rates—which we see in these high real interest rates—and it implies a dependence on foreign borrowing and potential problems with the dollar, even though the dollar has been exceedingly strong for several years, continuing right through the current.

GREATER SAVINGS THAN PRESIDENT PROPOSES NEEDED

Senator Gorton. Let us go to the budget, and this question, at least, I am not asking for any critique of the patterns of spending cuts whatsoever. With respect to the goals, however, do you find the President's goals to be sufficient—do you agree with them, or do you think we need greater savings than the President proposes, either in fiscal 1986 or in the years beyond?

Mr. **Volcker**. I would clearly rather see more savings. And the more savings you can do, I think the safer we are, the better the future would be. There are practical limitations on how much you can achieve, and it is in that context that I have expressed the judgment that upwards of $50 billion of real savings—savings that are going to compound further out in the future as the Administration says theirs would—and I have no reason to doubt that—would begin to make the kind of impact that turns this curve down and to provide a degree of reassurance to markets that might find a reflection in actual market developments, even before the spending cuts took place.

But when I say that, I am making a psychological judgment as much as an economic judgment. All I would say is the more, the better, within the practical limits of what you can do.

ACHIEVE DEFICIT REDUCTIONS ON SPENDING SIDE

Senator Gorton. From the perspective of encouraging economic growth and a reasonably noninflationary economy, is it preferable to achieve these deficit reductions on the spending side or on the taxing side?

Mr. **Volcker**. If I look at it totally as an economic proposition, what is best for economic growth over a period of time, I would say do it on the spending side. But then, of course, we begin running across priorities other than what may be best for economic growth over a period of time. I have always said if you cannot do it on the spending side, then I think this needs and demands enough priority that you have to look at the revenue side. From the economic standpoint, it is better on the spending side.

Senator **Gorton**. In order to achieve those goals on the spending side, or such a portion of them as we should decide to attain on the spending side, is it your view that the entire budget must be included in the exercise, all major spending programs, and that future year savings from restraint in the defense budget is appropriate and even necessary?

Mr. **Volcker**. That begins to get into the area where you have to reconcile all these competing demands. All I would say is that to do a lot, it just looks to an outside observer like myself that you have got to cover a broad range of programs.

Senator **Gorton**. Senator Chiles.

INTEREST ON FOREIGN DEBT WILL LOWER STANDARD OF LIVING

Senator **Chiles**. Mr. Chairman, we have heard many times that foreign capital inflows have kept the U.S. interest rates lower than they might have otherwise been.

I wonder if these inflows are merely putting off the day of reckoning, and if eventually, as we keep spewing out these enormous amounts of debt, foreigners will be willing to accommodate us only if we offer them higher and higher interest rates. And then, as the interest rates rise, we see our interest-sensitive sectors getting crowded out of the credit market.

I wonder what putting off the day of reckoning will mean to the price tag? We know that we have just become an international debtor for the first time in postwar history. If current trends continue, we could owe foreigners $1 trillion by the early part of the next decade.

Can you tell us, in your view, whether the interest and principal on this enormous foreign debt will lower the future standard of living for America.

Mr. **Volcker**. I cannot tell you——

Senator **Chiles**. Obviously, that has to be balanced out at some future time.

Mr. **Volcker**. Right. And I cannot answer the first part of your question about how long it can last. It depends upon our interest rates, our confidence in the American economy, as we discussed before, which in turn will be related to our performance. I think our success in dealing with inflation is terribly important there.

But I agree with the implication in your statement, that at some point it has got to come to an end. As that deficit accumulates and the foreign indebtedness accumulates, yes, it will reduce the standard of living of our children; or before our children grow up, it will be reduced because we have to pay interest on that debt. And as the debt piles up, and we cannot count on the continuing inflow, payment of that debt will require that we export more and import less, and that is a part of a lower standard of living.

The other side of the coin is that we are, in a sense, living beyond our means now.

Senator **Chiles**. So in effect, as we live beyond our means now, we are just locking in a situation where we will have to live——

Mr. **Volcker**. At some point, you will have to pay that back.

Senator **Chiles** [continuing]. We will have to pay that back in the future. And the longer it goes, and the bigger it gets, the tougher the payback will have to be.

Mr. **Volcker**. At some point in the future. I do not know when that point is.

FED HAS BEEN WILLING TO KEEP EXPANSION GOING

Senator **Chiles**. That is the one thing that we do not seem to know.

Last year, you managed to keep the growth of the M-1 and M-2 within their target ranges. During the second half of the year, there was a period when both money growth and the real growth of the economy slowed markedly. After that, you seemed to follow a policy of temporary monetary ease to put the economy back on track.

So it seems to me the Fed has been willing to do some fine-tuning to try to help to keep the expansion going. We are in the third year of the economy recovery, and if history is a guide, we can expect credit demands to grow, causing an increasing conflict between private and Federal credit demands. That seems to be part of the thesis of the forecast you were reading.

Mr. **Volcker**. Yes.

Senator **Chiles**. You have often expressed—and I know you are sincere in this—that you are determined to pursue a monetary policy that leads toward long-term price stability.

If significant action is not taken this year to reduce the deficit, do you believe that you will have continued freedom to keep this expansion going? Or are you afraid that you might eventually have to choose between the recession and inflation?

Mr. VOLCKER. I think the immediate past performance on inflation has been good, and the immediate outlook looks pretty good. But I accept the implication of your statement, that this Federal financing, on top of growing private financing through the pressures that it creates in the market, or on the external position, or on both, create the classic kind of condition that has put pressure on our monetary authority to create too much money. That is self-defeating in my judgment, because as soon as we begin to do that, nothing would be more calculated to undermine the confidence that we were talking about that keeps this whole process going.

So, as a practical matter, I do not think we have that option open to us. But the situation has built-in pressures in that direction, and if those pressures are not manifested in increases in the money supply that are excessive, which I think we must resist, you have this threat, to interest rates, to capital markets, and to the business expansion. That is one way of looking at our dilemma, and I would like to see it eased.

Senator CHILES. As I listen to your scholarly answer, it seems you are saying you have not changed your stripes; you do not intend, if we do not do the job, and something has to tighten up to allow the money to grow enough to take care of the problem.

Mr. VOLCKER. Right. I do not think we have the option of inflating this problem away. I think that would only greatly aggravate the problem. That would be defeat.

SOME TAX CHANGES COULD HELP LOWER DEFICIT

Senator CHILES. You have been one of the staunchest allies in calling for reductions in these enormous deficits. We now have the President's budget, and when we re-estimate his deficits, using the CBO economic assumptions, which also happen to be the consensus forecast, we find that he comes up about $118 billion short over the next 3 years of achieving the staged reduction of the deficit, getting it to 2 percent of the GNP by 1988.

As Chairman Domenici said, even a comprehensive freeze on spending including defense, Social Security, COLA's, everything that can be frozen, still comes up short of the mark by about the same amount. You have said in your answer to questions from Senator Gorton that, while you believe we should try to do everything we can on the spending side, after we have done what we can, we should look at the revenue side, rather than allow those deficits to stay out of control.

Assume we do everything we can on the spending side, and we eventually feel that to get down to the amount that is going to allow us to be safe, we have to look at the revenue side. Would you say it would be preferable to close the gap by looking at some of the tax expenditures that the Treasury and the congressional tax reform plans have slated for revision, rather than raising individual tax rates?

Mr. VOLCKER. At the risk of a scholarly answer, I certainly think I would look for revenues and tax changes that would have the least effect on investment and incentives, and I think that might go in the direction that you indicate; it might go toward certain kinds of taxes. There has been some discussion of an energy tax, for instance, a gasoline tax, or other excise taxes. There are a variety of possibilities. But I think indeed, marginal tax rates are so high that we would not want to damage the very incentives that we count on to sustain growth over a longer period of time if we can avoid it.

FEDERAL RESERVE CRITICIZED FOR TIGHT MONETARY POLICY

Senator CHILES. Look at the latest Economic Report of the President. It shows that once again, the administration's desire to have it both ways. They have stepped forward to take the credit for the decline in inflation and stepped back so that you could get the credit for the recession that went with it.

Many times over the last 4 years, former Treasury Secretary Regan has criticized the Federal Reserve for pursuing a tight monetary policy. We know he has renewed these attacks recently.

I would just like to know whether you think we could have made such great progress against inflation if you had increased the growth of money as the administration desired?

Mr. VOLCKER. Let me say with reference to that earlier period, as you suggested, we had a very difficult problem, and I do not think we were going to get out of that problem of accelerating inflation—with the benefit of hindsight, or even with the benefit of foresight—without some very serious strains in the economy. We indeed did have them.

The relevant question is whether we benefitted from those adjustments. I think there is a lot of evidence that we have. I found the comment a little odd from a monetarist's point of view, which is where it came from, because the money supply was steadily rising above our target during 1982, and there was a considerable amount of criticism at that time that the monetary growth was too rapid.

I think the difficulties during that period were a reflection of the difficulties in the economy and the need to make some very radical changes if the accelerating inflation was going to be brought around to decelerating inflation; and we are the stronger for it at the moment.

Senator CHILES. Has the President ever asked you to pursue an easier monetary policy?

Mr. VOLCKER. I do not know whether he has expressed it quite in those words, but sometimes there have been comments by the administration about the money supply——

Senator CHILES. I know they have sent you some messages before.

Mr. VOLCKER. They seem to be more frequent when the money supply is running low than when it is running high, in my observation. [Laughter.]

Senator CHILES. I yield.

Senator GORTON. Senator Boschwitz.

SEVERE STRAINS ON LARGE PORTIONS OF AGRICULTURAL SECTOR

Senator Boschwitz. Mr. Chairman, I am sorry that I missed your opening statement, but I really do not feel that I did miss it, because as Senator Chiles has mentioned, you have not changed your stripes at all as long as I have been listening to you. Your message has been very consistent and very persistent, and I presume, as I scan the testimony this morning, that it indeed continues to be that way.

I note that our chairman in this morning's paper was cautiously optimistic that we would achieve a $50 to $54 billion deficit reduction package. He spoke about the freeze on Social Security, which I would join him in, and the freeze on other aspects of the budget, in which I would also join him, plus reductions in some programmatic expenditures.

So, I join him in that cautious optimism, and hopefully, we will put together that package that you have spoken to us about so often, that I think is extremely necessary.

I would like to get your assessment of the agricultural situation, agricultural borrowing and the threats that you see attendant to that.

Mr. Volcker. I do not think there is any question that there are very severe strains on large portions of the agricultural sector of the economy. It appears that, because of a combination of circumstances, some heavily indebted farmers, of which there are a considerable number, are faced with both current interest rates, declining land prices, and, from their point of view, at least, depressed crop prices, and they are not going to be able to make it.

I think that creates a serious problem in and of itself for those farmers when it feeds back on rural banks and agricultural banks. Those banks have fortunately been in good shape, historically, with good earnings and good capital. But they are going to need every bit of that strength to deal with this problem and the pressures that will be upon them, in many cases.

Senator Boschwitz. There is about $215 billion of this debt, farm debt, total, land and operating debt——

Mr. Volcker. Only about $50 billion of that in banks.

Senator Boschwitz [continuing]. Sixty billion in banks, and a large amount of it is held privately?

Mr. Volcker. A large amount of it is held by the Farm Credit Administration, Farmers Home Administration. Some of it is held privately by individuals, insurance companies, others.

Senator Boschwitz. Insurance companies, as well. And in our part of the country, the Farmers Home Administration is not nearly as prominent in its lending as it has been in the Southern States, so that we deal with the Land Bank and private holders are as big, even, as the Land Bank, which take some of that pressure off.

Mr. Volcker. That is right.

LOT OF PRESSURE ON AGRICULTURAL BANKS

Senator Boschwitz. But do you consider that there is much pressure on the banking system?

Mr. VOLCKER. There is a lot of pressure, or will be a lot of pressure on agricultural banks. You say "banking system"; that is a limited small sector of the total banking system in the United States. Obviously, it is not a negligible sector.

But I would want to make a distinction between the pressure on that sector of the banking system and the banking system as a whole. I think these pressures from a systemic standpoint are manageable.

Senator BOSCHWITZ. Have you examined the package that was put together between the administration and some of us on the Hill—and I wonder if you would assess that and to what degree that will alleviate the problems.

Mr. VOLCKER. You are thinking of the short-term package.

Senator BOSCHWITZ. Yes.

Mr. VOLCKER. I have looked at it to some extent, yes, and I think it obviously goes in the direction of alleviating some of these problems. Some of those steps that involve banking regulatory agencies, we already have in place, in effect, in the sense that we have strongly indicated to our examiners that they are to permit forebearance where there is some reasonable chance that the farmer can make it over a period of time, and that should not be discouraged——

Senator BOSCHWITZ. When did you make that——

Mr. VOLCKER. We first did it probably about 18 months ago, and we have reiterated it several times since then. We put in, in fact, another level of supervisory approval. If farm loans are going to be classified, they have to be referred up the line, so to speak, to make sure that these are being done only in necessary cases.

Senator BOSCHWITZ. Is that a recent development?

Mr. VOLCKER. We did that 8 months ago or so, I think in July.

EXCHANGE RATE

Senator BOSCHWITZ. I believe we talked about it in the middle of last year,and I talked to Mr. Isaacs, and also the Comptroller, Mr. Conover, at that time, because I felt that many of those loans were in jeopardy.

One of the other things, of course, that beleagers the farmers is the very high exchange rate. I wonder what you foresee as you look outward on the exchange rate, and whether or not—exchange rates have gone up and down like everything else in the economy, of course—what is the outlook, in your judgment, on the exchange rates?

You are shaking your head——

Mr. VOLCKER. I am going to plead innocence on that one, Senator. I would not have guessed that the exchange rate wold have been where it now is. It has moved up almost steadily in the past several years and over the past year. Our trade position has deteriorated, meanwhile; our interest rates have come down in recent months, and the exchange rate continues to rise. We have had some traditional indicators of weakening of exchange rates, and the exchange rate goes up right in the face of that, and I do not think I am going to try to predict what it is going to do in the future.

Senator BOSCHWITZ. With this extraordinary imbalance of trade, one would think that the exchange rate——

Mr. VOLCKER. Sooner or later.

Senator BOSCHWITZ [continuing]. Would weaken, would relax.

SUSTAINABILITY OF CAPITAL FLOW

Mr. VOLCKER. I think that is a force that would suggest that it would sooner or later, but we have an awful lot of capital coming into the country. What you are talking about is the sustainability of that capital flow; we had a dialog about that earlier. I do not think that will persist forever, but I would not be so bold as to suggest how long it could go on. It depends partly on events abroad, not just here. Most other industrialized countries, particularly in Europe, have found their economies rather sluggish, and there have been political uncertainties; all of this has, I think, helped induce people to put money in the United States.

We are talking about a net flow; it is the difference between the inflow and the outflow. Part of the reason it is going up is that the outflow has been very substantially reduced. Our banks are not lending abroad, for instance, in Latin America and elsewhere, the way they did in earlier years. When they pull back their foreign lending, it shows up in the statistics as an increase in net inflows, even though the foreigner may have done nothing. It has taken place from both directions—some increased inflow, apparently, and a considerably reduced outflow.

INTEREST WRITE-DOWN

Senator BOSCHWITZ. We, in that credit package, made some conditions on some banks, making them either write down principal by 10 percent, or more, in some instances, or in exchange for that, writing down interest in varying degrees in order to make a loan cash flow.

Is it unreasonable to ask banks to write down principal by 10 percent?

Mr. VOLCKER. No, I do not think it is unreasonable. I take it they prefer the option of writing down the interest, in many cases. But the concept of that program, it strikes me, is a reasonable one, that some assistance is provided where losses are absorbed by the bank and where the assistance is designed to enable a farmer who can make it to stay in business "who can cash flow," in your terms.

To administer a program of that sort, I can imagine, has many difficulties, and much burden is put on the banks, but the concept of it, I think, is not unreasonable.

Senator BOSCHWITZ. I must say the banks raised no objection when we came out in September with the a principal write-down program, but then they did not use that at all. Instead they decided they wanted the interest write-down, and now that they have gotten that, they want to have an interest buy-down, which we are not going to give them. Very frankly, they were out there, hawking their money to the farmers, and were part of the problem in creating some of those loans, so at least in my judgment and in my view, we are not going to go any further. The banks will have to make up their minds whether or not they are going to swallow some of those portions of those loans or some portion of the interest themselves.

The exchange rate is probably the principal problem that the farmers face, together with the interest rates. If exchange rates would come down, we would be in much better shape.

Suppose we subsidize some exports to offset the exchange rate, and suppose we keyed that subsidy to the exchange rate so that as the exchange rate levelled, we would remove the subsidy; what would be your reaction to that?

EXCHANGE RATE/PRICE RELATIONSHIP

Mr. **Volcker**. Well, in my own opinion, what you are interested in and what the farmer is interested in is the price of corn or wheat. I think that is not independent of the exchange rate, but I do not think it is any simple, one-for-one relationship. I do not know how you would structure a program of the sort that you are thinking of that would make sense over a period of time, because I think that relationship can vary—apart from the problems, as a matter of trade policy, from a big, new subsidization program, and I suppose apart from the budgetary problems as well.

Senator **Boschwitz**. Well, that subsidy, of course, could be in goods, for which there is already authority, and the subsidy could also, perhaps, be related to other subsidies that farmers have to face in the international markets.

It is something that we are certainly giving consideration to, because that is a very positive part—we still have more than a two-for-one trade balance in that area, and at one time, it was nearly 3-to-1, and it is an area in which we certainly could continue to expand.

Thank you, Mr. Chairman.

Senator **Gorton**. Senator Sasser.

Senator **Sasser**. Thank you, Mr. Chairman.

Good morning, Mr. Chairman.

Mr. **Volcker**. Good morning.

REASONS FOR HIGH DEFICITS

Senator **Sasser**. Mr. Chairman, you have been telling us for a number of years, and you have had very distinguished company in telling us this, that if we did not do something about the deficit, there were going to be very, very serious repercussions. I think you have been telling us that now for 6 years. As I say, you have had distinguished company—Alan Greenspan on one side and Walter Heller on the other, and Henry Kaufman, have all been saying the same thing. Well, now, we have had these terrible deficits, the worst in the history of this country, for the past 4 years, but we have had the lowest inflation rate this past year in almost two decades; the highest increase in real income in 21 years, and the GNP just continues to go up by very, very substantial numbers.

We have got fairly high real interest rates, but it does not seem to be really doing much damage, except to our farmers and some who seek to export, but to the average man on the street, things could not be better.

Sometimes I think maybe Ronald Reagan and Jack Kemp know something that maybe some of the rest of us do not know.

Mr. **Volcker**. I thought maybe you were going to suggest it was good monetary policy, Senator. [Laughter.]

Senator **Sasser**. Maybe it is, maybe it is.

What is the reason for this? I have been thinking about it. And you tell us this morning we are financing a large portion of our debt with foreign capital inflows.

The Japanese run, I am told, higher deficits in relation to GNP than we do here in the United States. They have the second, I think, most productive economy in this world, and they finance their deficit internally, through internal savings, and they have got the highest savings rate. We just go abroad and finance our deficit. And both of the economies continue to roar along here, doing very well.

What is wrong? Why are we continuing to run these high deficits and we do not have the apocalyptic results that we had anticipated 6 years ago, 5 years ago, 4 years ago, 3 years ago? We just keep on going along.

CONTRAST BETWEEN UNITED STATES AND JAPANESE DEFICITS

Mr. **Volcker**. Let us pick up this contrast between Japan and the United States. I think their deficit is a little lower than ours now, relative to GNP, but whether it is a little lower or a little higher it has been sizeable.

We save about 8.5 percent of our GNP; they save about 20 percent of theirs, so they can finance that deficit of 4 or 5 percent of the GNP and have 15 percent left-over. They can have very high investment at home and lend us a lot of money. A lot of that money is coming into the United States. We are in the opposite position. We have got a 5 percent deficit or thereabouts; 6.5 percent private investment; we are borrowing 3 percent of our GNP overseas. A lot of it comes from Japan. I would rather be on the lending side of that equation than the borrowing side. They have a $35 billion current account surplus, strong industrial investment, strong exports. We have enormous pressures on our agriculture area; our heavy industry has not shared in this glorious picture of the economy that you have described, which I agree with——

Senator **Sasser**. Well, I am just borrowing the rhetoric from the President's State of the Union Address of a couple of days ago.

Mr **Volcker**. I agree that overall the economy has done very well, but there are great imbalances in it. Those imbalances are part of the story. From most people's viewpoint, the economy has been quite satisfactory, no doubt about it, it has been quite satisfactory; the inflation progress has been remarkable; people are feeling better for good reason. But I think that progress is flawed as long as so much of it is dependent upon a continuing inflow of foreign capital that, by its very nature, can be skittish.

To take an extreme example, we are a much stronger country than all the rest, and I recognize that, but in Latin America 4 years ago, and they were growing at 6 percent a year, at historically fast growth rates; they were borrowing a tremendous amount from abroad relative to their GNP, but the banks were lending money very freely. Every bank had lending offices down there, offering them money at thinner and thinner spreads. It looked wonderful while it was lasting, but it did not last forever. Nobody could have predicted when that was going to change, but when it changed, it changed very abruptly.

ENCOURAGE FOREIGN CAPITAL TO CONTINUE

Senator SASSER. What is it going to take, in your judgment, to encourage foreign capital to continue to come into this country—continued high interest rates?

Mr. VOLCKER. Good economic performance. And I would probably rank as number one a sense of stability and the price factor and monetary policy are extremely important factors in that.

High real interest rates are a factor. Growth and dynamism, a feeling that we have a free and liberal economy, I think, is an important continuing structural factor. But you have got to look at the other side of the coin, too; These flows are affected by how people are evaluating the rest of the world. We are now, in a sense, vulnerable to success elsewhere. If people felt better about the European economies, they would want to keep more of that savings at home, which would create a problem for us. That is not a very good position to be in, that is when you may suffer from the success of others. There has not been all that much success in Europe recently.

Senator SASSER. Well, it seems to me if our rates continue high, and we continue to attract foreign capital into this country, don't foreign investors at some point just become saturated with our dollar security?

Mr. VOLCKER. I think eventually, yes. I would be a brave man to predict when that takes place. But if you are accumulating debts at $100 billion a year, and then you have to pay the interest on that, so it accumulates faster the next year, at some point, yes, I feel confident they will be saturated. But whether that is 1 year or 5 years from now, I do not know.

CROWDING OUT OF PRIVATE INVESTOR

Senator SASSER. The crowding out of the private investor by Government, or private borrower by Government, we were all so concerned about 2 or 3 years ago really has not occurred because of the inflow of foreign capital, has it?

Mr. VOLCKER. I think it has occurred. It has just occurred in a different form, if I may suggest it, Senator. The people who have gotten crowded out are the exporters, the farmers, those competing with imports. They get crowded out through this rise in the trade deficit.

Let me illustrate the point. You think of crowding out as taking place in terms of the housing industry, the most vulnerable to higher interest rates. Well, housing has been pretty well-maintained. But the decline in our trade balance over the last 2 years has been on the order of $100 billion; $100 billion is equal to two-thirds of the size of the housing industry. In other words, if we had not had that trade deficit, so that we bottled up all of these forces internally, and it impacted on the housing industry, we would have kissed two-thirds of the housing industry goodbye.

Senator **Sasser**. All right, Mr. Chairman. Thank you very much.

Senator **Gorton**. Senator Quayle.

WHAT FINANCIAL MARKETS ARE EXPECTING

Senator **Quayle**. Good morning, Chairman Volcker.

In this town, and in this whole political system of ours, it seems that we pay more attention to expectations or perceptions than we do to reality.

I wonder if you could tell us what do the financial markets expect, not necessarily what they hope for, but what amount of cuts they expect the Congress to enact in this deficit reduction package? What do experts such as yourself whisper in their ear?

Mr. **Volcker**. I will answer your first question. I will not answer your second question, because I try not to whisper——

But I have asked a number of people, for what it is worth, what they really think the markets are expecting now. I do not have a high degree of confidence in these answers, because nobody knows, but the kind of——

Senator **Quayle**. Yes; but a consensus is going to be developed out there.

Mr. **Volcker** [continuing]. Yes; the consensus, I would judge, is on something like $25 billion, maybe a little more, to the optimists.

Senator **Quayle**. $25 billion in savings?

Mr. **Volcker**. In savings, yes.

Senator **Quayle**. Are they anticipating any kind of a tax change? Do they anticipate that tax simplification, for example?

Mr. **Volcker**. I do not know. I do not have any sense of any very well-settled expectations about that.

Senator **Quayle**. OK. But they basically feel, that the Congress will probably, in real savings——

Mr. **Volcker**. Do something, but not very much.

CUT SPENDING TO CLOSE GNP/DEFICIT GAP

Senator **Quayle** [continuing]. About half of what we propose.

If your goal was to have just economic growth—and I think that that is probably the goal that we ought to have—and to close that deficit equal to 5-percent GNP would it best be closed through spending restraint or tax increases, so-called revenue enhancement? If given the choice—taxes or spending cuts—which promotes economic growth?

Mr. **Volcker**. As I said when the question came up before, you would do it on the spending side.

Senator **Quayle**. Do it all on the spending side.

Mr. **Volcker**. I am not saying small changes in taxes are not going to make much difference, but in principle, you would do it on the spending side.

REVENUE AND EXPENDITURE GOALS AS PERCENT OF GNP

Senator **Quayle**. I know you have been asked this in the past, but maybe you have not been specific. At what point, such as a percentage of GNP, should revenues and expenditures meet? Right now, we have a gap of 5 percent of GNP—expenditures are somewhere around 24 percent and revenues are about 19 percent.

Mr. VOLCKER. Yes; 24 and 19.

Senator QUAYLE. Do you have in mind, as far as goals and objectives; whether the budget should be balanced at 20, 21, 21½ percent of GNP?

Mr. VOLCKER. No.

Senator QUAYLE. Do you think that is an important goal to discuss?

Mr. VOLCKER. Yes; it can be important to discuss, but I do not think the answer to it is economic. From an economic standpoint, just carrying out the logic of your story about spending in terms of growth, the smaller, the better. But obviously, the Government has other responsibilities. You have got defense to worry about, you have got social programs to worry about, and all the rest. That is why we have a government. I cannot, within a reasonably broad range, tell you what the ideal number is—although I think you could argue, at least without tax reform, without a different kind of tax system, that we seem to be straining what we can do at 19, because the tax rates get so high. But that is a function of the particular tax system we have. I think we could probably manage without grave damage to economic incentives and growth a higher revenue scheme if we had a different kind of a tax.

VALUE-ADDED TAX

Senator QUAYLE. When you are looking at a different kind of tax system, are you basically referring to either broadening the tax base, or looking at some sort of energy tax?

Mr. VOLCKER. Yes; or a still broader excise tax, a value-added tax kind of approach. There are those kinds of alternatives, the broader tax base, the consumption tax, perhaps energy tax, although that would not do the whole thing.

Senator QUAYLE. Other countries that have developed the value-added tax approach, what has been their experience on economic growth? Haven't they basically had difficulties with economic growth on a value-added tax, or is the answer in reverse?

Mr. VOLCKER. I do not think you could make that generalization. By and large——

Senator QUAYLE. Which countries have a value-added tax?

Mr. VOLCKER. The European countries, basically, have value-added taxes.

Senator QUAYLE. Basically, what has been the economic growth rate in European countries in the last decade since they have expanded the value-added tax?

Mr. VOLCKER. They have had value-added taxes or something similar for a long time, and recently, they have not been doing well on growth. But earlier, they were doing quite well, or many of them were. I think this is the significant point, they all have a level of government expenditures way above what we have, relative to the GNP. I am not arguing that is a good thing, but they have been able to support that, I think, partly because they have relied on the value-added tax. They would be better off, perhaps, if everything were lower, but they have been able to support a much higher level of government spending.

LEVEL OF SPENDING ON GNP

Senator **Quayle**. Do you know offhand what their level of spending is on GNP?

Mr. **Volcker**. Some of them have about 50 percent. Most of them are, I think, in about the 45 percent area now—that is total government--compared to our 33.

Senator **Quayle**. Yes, if you take State and local government, we are around 40 percent ourselves, aren't we?

Mr. **Volcker**. No. We are 34.4, estimated, last year; Italy, 56; United Kingdom, 45.5; France, 52; Germany, 46; Japan, 34. That is an attempt to make these figures comparable.

Senator **Quayle**. OK.

Mr. **Volcker**. The other low one is Japan, as you can see. It is about the same as we are. It is low in the international league. You may not think it is low in absolute size.

Senator **Quayle**. About 34 total.

Mr. **Volcker**. About 34.

Senator **Quayle**. For some reason, I guess I thought ours was higher than that. I presume that 34 percent is the sum of State and local spending.

Mr. **Volcker**. This includes State and local, yes.

ECONOMIC GROWTH FORECAST

Senator **Quayle**. OK. If you had to look 12 months ahead—that seems to be about as far as anybody can gaze, do you think that there seems to be a consensus I suppose these consensuses change like budget numbers change——

Mr. **Volcker**. Right.

Senator **Quayle**. But I mean, if you had to say right now, "OK, Budget Committee, in the next 12 months, the economic growth compared to last year"—are we going to have as good a year in GNP as last year, or not as good, or do you think there is a possibility that we could have better? Can you give us a forecast?

Mr. **Volcker**. We will be giving our official forecast in a couple of weeks.

Senator **Quayle**. Well, do you want to break a major story right here, or——

Mr. **Volcker**. No. We have got to go through the committee, but let me say you have a forecast of the administration of around 4 percent real growth; the CBO, 3.5 percent or a little higher.

Senator **Quayle**. Yours would not vary too much from that?

Mr. **Volcker**. It would not vary too much from that. That is a slower growth than we had last year; it is quite healthy growth, but it is lower than we had last year.

INFLATION FEAR DIMINISHING

Senator **Quayle**. Is the inflation scare still out there?

Mr. **Volcker**. It is diminishing.

Senator QUAYLE. In 1981, 1982 and 1983, your policy was, "By golly, we are going to get rid of that inflation fear and the inflation psychology that we have built up over the past decade." You have made that statement, and now it seems for all practical purposes, that most forecasts you look at for the next 12 months, at least, and maybe even beyond that, say inflation is going to be 5 percent or less.

Mr. VOLCKER. Yes.

Senator QUAYLE. And I think that is a fairly solid figure. If that is the case, do we really have a fear of renewed inflation in the financial markets?

Mr. VOLCKER. If you say taken care of, I would say no. Greatly improved, greatly muted—yes.

Senator QUAYLE. What is their big fear that inflation could possibly take off again?

Mr. VOLCKER. The invariable answer I get to that question from those to whom I talk who still fear inflation or fear it may come back is: "I simply do not believe that we can keep inflation low while you are interminably running budget deficits of $200 billion plus." That is virtually a uniform answer that we get. Whether it is a factor or not is irrelevant; you were talking about perception, and that is the perception.

Senator QUAYLE. Yes; that is a strange thing, because the deficits have been going up, and inflation has come down. Maybe there is no correlation. If we start throwing these figures around like that, then some of us will be sitting around and scratching our heads and trying to figure out what really is the cause of this inflation psychology.

Mr. VOLCKER. This is always a confusing picture, but let us try to say again, what my concern would be and what I think your concern should be is the underlying deficit, the structural deficit, the full employment deficit, whatever you call it, which is rising and has been rising through this period. The bigger deficits or the larger deficits that we had in 1982, 1983 were in substantial part recession—induced. That kind of a deficit is much less threatening, in my judgment, than the structural deficit. What these people are saying, rightly or wrongly, is that they cannot conceive of a full employment economy, so to speak, running a deficit of this size without such great pressures on growth in the money supply that will eventually result in inflation. And that is not a foolish fear. And I think we can avoid that in the United States, but there is a lot of history around the world that says the process works just that way.

Senator QUAYLE. Once the pressure on the monetary supply goes, then you are going to see the——

Mr. VOLCKER. That is right. And remember, all of human history, economically, is the sovereign clipping the coinage to meet his expenses; that threat is the modern version. That is presumably why we have an independent central bank, to try to resist that temptation.

Senator QUAYLE. Well, as long as that independent, respected bank continues to operate in an expected, reasonable, comfortable fashion, that independence and integrity will be preserved.

Mr. VOLCKER. It provides me with a certain amount of comfort, Senator.

DEFICITS ARE HUGE PROBLEM

Senator QUAYLE. Well, I think when things are going well the political pressures are abated considerably. It is when things start not going well—you know that pressures mount. No one has tried to lynch you here this morning. But if this farm credit thing does not get resolved, and if interest rates would somehow take a turn for the worse, which would be unexpected, or something like that, if you come back here, there would be a lot more people here, with ropes and things like that. But today, at least things appear to be moving ahead. I agree with you, and I do not think anybody disagrees, that these deficits are a huge problem, not only in the near-term, but particularly in the long-term. But when you start adding up all these expectations and perceptions and start matching what really the fear is out there and rub them together, then there is a degree of finagling back and forth and complexity that is sometimes difficult to explain.

Mr. VOLCKER. I agree that these perceptions can be very volatile, but perceptions are also a fact that we have to deal with, and some of them are well-based.

Senator QUAYLE. Thank you very much, Mr. Chairman.

Senator GORTON. Senator Exon.

NEW FORBEARANCE POLICY

Senator EXON. Thank you, Mr. Chairman, and let me add my welcome to you, Chairman Volcker, for being here with us today.

I first want to compliment you on the excellent relationship we have had with your office with regard to meetings. You have been very generous with your time. I do not know how many times I have met with you in the past year, but it has been several occasions, and you have been very forthcoming in that area, and I for one appreciate that, and I think most of the members of the committee agree.

As you know, I have met with you on several occasions, with bankers and farmers and others, dating back well over a year ago, with regard to the squeeze that many of us saw coming, a very desperate squeeze, in the whole credit picture in rural America.

I was therefore happy that finally and at long last, 2 days ago, the administration finally recognized forbearance as something that is somewhat necessary out there today. When I talk about forbearance, I can say something that I think you would want to say. I do not think we have ever requested that you or the other regulatory agencies turn your backs and keep financial institutions in business just to fool the public, because we do not want that.

But we have had some concerns about the auditing techniques and the liquidity of financial institutions and the fact that there may have been some overenthusiasm, for want of another word, from some of the regulators who basically did not understand the credit system and did not have the experience and background to say whether that loan or this loan was actually one that belonged on some kind of a questionable list.

My question is, the administration announced as a part of their plan the other day that they were indeed calling upon the regulatory agencies, of which yours is an important one, to give forbearance. And I was delighted to see that. Could you outline specifically for the committee what arrangements of a recent nature have been made with your agency, what contact have you had with the President or his representatives, or the Secretary of Agriculture, or David Stockman, or other "farm boosters". [Laughter.]

Senator EXON. What is going to happen, and what is the new forbearance policy that the Administration announced?

OLD FORBEARANCE POLICY BEING CARRIED OUT

Mr. VOLCKER. We have had a lot of contacts recently, without excluding any possibility of improvement. My understanding is that the new forbearance policy will be our old forbearance policy.

As you suggested, we instituted with some care some measures to avoid unnecessary and undue pressure on either banks or the borrowers where there seemed to be in the judgment of the bank in particular an opportunity to forbear and reasonable prospect that the farmer could work out of his situation and eventually resume adequate debt service.

We do not want to put supervisory pressure to treat them differently if, indeed, the facts justify that kind of treatment—without, as you say, just turning our backs on truly bad loans, truly bad banks. And we have instituted some supervisory systems and checks, as you indicated, to try to make sure that that policy is carried out throughout the system.

Now, I am sure that we can have further discussions, and will have, in connection with the general interest in this subject, and maybe some further technique can be developed. But, as of the moment, we are proceeding with these approaches that we put in place some time ago.

NO CHANGES IN POLICY ANTICIPATED

Senator EXON. So it is fair to say that there is not anything new or dramatic or even anything now anticipated that would change whatever the policy has been and however that policy has changed to some degree up until now?

Mr. VOLCKER. We have a constant problem in making sure it is effectively implemented, and I would not rule out some improvements; certainly, we will have some discussion to see whether changes can be made, but I do not anticipate anything dramatic in that particular area right now.

Senator EXON. Has there been a recent meeting between yourself and Bill Isaac of the FDIC, and others, where you have all sat down with the administration officials and tried to develop some kind of a plan?

Mr. VOLCKER. Not to my knowledge. I think there will be such meetings, and I have asked the Vice Chairman to follow this immediately. He may have had a meeting in the last few days, but I am not aware of it.

SHRINKAGE IN AGRICULTURAL CREDIT

Senator **Exon**. Let me ask this question, Mr. Chairman. How much of a shift has there been in percentages by the banking system of America away from agricultural credit into other lines of credit or purchase of some highly secured type of bonds or T-bills?

I am asking how much of a shrinkage has there been in the amount of money that has been invested in agriculture as to what it was, say, 4 years ago. Do you have any idea?

Mr. **Volcker**. I am not aware of any shrinkage in the banking system. I think banks loans to agriculture have gone up over that period. I do not have the data in front of me, but I think that that is true.

Senator **Exon**. I wish you would check that for the record. There are an awful lot of banks trying to get out of agricultural loans today, and I have heard some statistics from some banks that would lead me to believe that there indeed has been a significant downgrading of the percentage of their loan portfolios in agriculture.

Could you supply that for the record?

Mr. **Volcker**. I could certainly supply it for the record. I am told that the total loans went up 8 percent in 1983 and about 6 percent in 1984. Now, it could be that the percentage of their total assets declined a shade, but the totals have certainly been going up.

We can supply all those figures for the record.

Senator **Exon**. If you would, I think it would be good if we could have a benchmark figure.

[The following was subsequently received for the record from Chairman Volcker:]

FARM LOANS OUTSTANDING AT ALL U.S. COMMERCIAL BANKS

[In billions of dollars]

	Dec. 31, 1980	Dec. 31, 1981	Dec. 31, 1982	Dec. 31, 1983	Sept. 31, 1984
Loans secured by farmland	$8.5	$8.3	$8.4	$9.3	$10.2
Loans to finance agricultural production and other loans to farmers	31.6	32.9	36.1	39.0	42.0
Total farm loans outstanding	40.1	41.2	43.5	48.3	52.2
Total bank loans and leases	1,002.2	1,113.1	1,202.3	1,288.0	1,440.8
Total bank assets	1,855.7	2,026.62	2,186.6	2,326.4	2,394.4
Farm loans as a percentage of total loans and leases	4.0	3.7	3.7	3.7	3.6
Farm loans as a percentage of total assets	2.2	2.0	2.0	2.1	2.2

FARM LOANS OUTSTANDING AT U.S. COMMERCIAL BANKS WITH ASSETS LESS THAN $300 MILLION

[In billions of dollars]

	Dec. 31, 1980	Dec. 31, 1981	Dec. 31, 1982	Dec. 31, 1983	Dec. 31, 1984
Loans secured by farmland	$7.1	$6.9	$6.8	$7.4	$8.1
Loans to finance agricultural production and other loans to farmers	24.2	25.1	27.2	28.8	31.1
Total farm loans outstanding	31.1	32.0	33.0	36.2	39.2
Total banks loans and leases	284.0	297.0	311.6	329.6	362.2

FARM LOANS OUTSTANDING AT U.S. COMMERCIAL BANKS WITH ASSETS LESS THAN $300 MILLION—Continued

[In billions of dollars]

	Dec. 31, 1980	Dec. 31, 1981	Dec. 31, 1982	Dec. 31, 1983	Dec. 31, 1984
Total bank assets	539.2	575.7	611.8	646.0	660.6
Farm loans as a percentage of total loans and leases	11.0	10.8	10.9	11.0	10.8
Farm loans as a percentage of total assets	5.8	5.6	5.6	5.6	5.9

PRESENT INTEREST RATE TO FOREIGNERS

Senator EXON. What is the lending rate today, the interest rate now in effect, to international governments or foreigners through the various international lending agencies that the United States participates in to a considerable extent? Is it 10 percent; is it 14 percent; is it 16? What is it?

Mr. VOLCKER. Well, the rates vary to some degree with the market. If I recollect correctly—and my judgment can be checked—the World Bank rate for new loans now would be something under 10 percent. I think they just reduced it to something under 10 percent.

Senator EXON. IMF?

Mr. VOLCKER. The IMF is related to short-term rates in the market at the time, so they would fluctuate. They would be very close to Treasury bill rates, that kind of thing, and their equivalent in other countries.

[The following was subsequently received for the record from Chairman Volcker:]

The World Bank announced in late January a new lending rate of 9.29 percent and a waiver of the front-end fee of 0.25 percent. The previous lending rate was 9.89 percent. In addition there is a commitment fee of 0.75 percent, bringing the effective lending rate to 10.3 percent. The loan is denominated in dollars, but a country must borrow in a basket of currencies. Payment of interest and principal is in the same basket of currencies as borrowed so that the borrower bears the foreign exchange risk.

The interest rate on IMF loans, which are denominated in SDR, a basket of five major currencies, was about 9 percent for the average borrower at the end of 1984. This rate would have been higher or lower for an individual borrower depending on the type and composition of resources borrowed from the Fund.

Senator EXON. Does it strike you as maybe not quite fair if we have money being lent by international lending agencies at under 10 percent in certain hard-pressed sectors of our economy, that I will not identify, but you will assume who I am talking about, are paying considerably higher rates than that, averaging somewhere around 13½ today?

Mr. VOLCKER. Well, of course, they are operating in private markets, and that is part of our system. You get rates in today's market, long-term money from the World Bank, at something under 10 percent, and something close to money market rates from the IMF. You are talking about intergovernmental loans that are, in a sense, outside the market system. When you are dealing with the IMF, you have an IMF program to go along with those interest rates that is not the happiest thing in the world, from the viewpoint of many of the borrowers. They demand compliance with economic programs that they participate in developing.

It is not exactly a free ride when you go to the IMF; quite the contrary. Very few countries go to the IMF for that cheap money. They want to stay as far away from the IMF as they can unless their problems are so great that they have to go and accept that kind of discipline.

GIVE U.S. INDUSTRIES SAME INTEREST RATE

Senator **Exon**. Wouldn't you say, though, Mr. Chairman, that if through international lending agencies, we are seeing some foreign countries get interest for less than 10 percent—and we think that is in our interest in the long run, I presume—that the same kind of consideration might be given to certain industries in the United States that are in deep trouble today, or, putting it another way, why are we loaning money abroad when we need it at home at an interest rate of some forebearance to help get things going? I mean, is that inconsistent?

Mr. **Volcker**. I do not think it is really inconsistent, particularly in the sense that that particular sector that you may be referring to has over the years had a good deal of government credit assistance and other kinds of assistance. I suspect the Farmers Home Administration has lent more money to farmers at reduced rates, and considerably lower rates, in many cases, than those of the international institutions—and in larger volume than any American contribution to these institutions.

I would point out that the World Bank rate is a world interest rate, so to speak. They average among all their borrowing rates, and they borrow much cheaper in other countries. They can borrow in Switzerland, I suppose, at 5 or 6 percent; at not much more than that in Germany. They have a kind of blended rate of many different currencies in countries where the interest rates are much lower.

Senator **Exon**. Would the Swiss be interested in loaning some 5 and 6 percent money to Nebraska farmers today? I mean, is that something I should explore?

Mr. **Volcker**. They probably are, directly or indirectly, in that the Swiss undoubtedly account for some of the inflow to the United States. That is an interest rate in Swiss francs. That is not a dollar interest rate; that is a Swiss franc interest rate.

Senator **Exon**. Well, what does that translate to in dollars?

Mr. **Volcker**. If they are going to lend in dollars, they want a dollar interest rate, so they will look to our market. If they lend in Swiss francs, they want a Swiss franc interest rate. If you want to borrow in Swiss francs, you can get a cheaper rate.

FARM CREDIT SYSTEM

Senator **Exon**. Your question leads me into my last question, then. You must take a pretty close look at the whole farm credit system——

Mr. **Volcker**. I try to.

Senator **Exon** [continuing]. Which has a direct bearing. In your view, what is the health or the degree of illness in that system today? I believe we have an upcoming date sometime around March 1 when a high percentage of the payments come due, for example, on the real estate loans that the farm credit system makes. And as you know, it is a very broad-based system that allows borrowing maybe at somewhat less, as a big structure, than they would be able to get individually to the co-ops and so forth.

What is your view of the fiscal soundness of that system today, where I have heard that there are some concerns that are being raised, with, I might add, the rather depressing precipitous drop in land values throughout the Farm Belt, in some cases up to 50 percent and more?

Mr. VOLCKER. I think we are fortunate that both with private commercial banks in agricultural areas and with the farm credit system, through the years, have had a successful record of earnings and have built their capital positions and ratios. The Farm Credit Administration taken as a whole, I think, has a capital ratio of over 10 percent. They are going to be strained in the sense that some of their loans are not going to be as good as they thought they were and had been, historically. I do not think there is any question of that. But fortunately, they do have a good deal of accumulated financial strength to absorb those strains.

SUPPLY SIDE ECONOMICS

Senator EXON. Well, my time is up. One last question, that I hope you do not take too long to answer, Mr. Chairman. As one of our real experts in this area, how effective do you feel supply side economics has been in the last 4 years as it affects the deficit?

Mr. VOLCKER. I do not think I would prolong an answer to that question. Different people mean different things when they say supply side economics. I think the economy has a chance, a very real chance, of prolonging a very satisfactory expansion, of returning to a greater degree of stability than we have seen in a long time. But I think that vision remains flawed—but not irreparably flawed, if you people can do something about that deficit.

Senator EXON. So, with some reduction in the deficit, you think there is a chance we could grow out of our problems?

Mr. VOLCKER. Yes, and I should have said earlier, when I stated that I do not think growth is going to end this deficit, that with a little help from policy—if you take some action to begin to get the deficit on a downtrend—obviously, growth can help enormously in keeping that process going. It needs a little shove or push to get the dynamics of the situation right, and I do not think they are right now.

Senator GORTON. A rather big shove, Mr. Chairman.

Mr. VOLCKER. A big shove, that is right. I cannot think of a stronger word than "shove," but it needs that impetus to get the compound interest, in effect, working in the other direction. Once the deficits begin going down, all those savings on debt service can be factored into the equation. Now, they all run against you.

Senator EXON. Thank you, Mr. Chairman.

Senator GORTON. Senator Sasser.

CONSEQUENCES OF HIGH VALUATION OF DOLLAR

Senator SASSER. Mr. Chairman, Senator Exon is understandably very concerned about what is happening in the agricultural sector of our economy and, quite frankly, so am I. And one of the reasons for the problem, I think, as you have articulated earlier, is the overvaluation of the dollar on the international money market. And I noted in a recent magazine article that Dr. Feldstein, the former Chairman of the Council of Economic Advisers, made the assertion that the dollar's value has increased by over 60 percent since 1980.

Just if you would, Mr. Chairman, discuss with us the economic consequences, not just in the agricultural sector of the economy, which we have already seen, but what are the consequences in the other sectors of our economy if we allow this dollar to remain at its current, very high level of valuation?

Mr. VOLCKER. There are pluses and minuses, Senator. The obvious adverse consequences are on those industries that compete with imports or export, and that is a very wide range of industries. You can see today this great economic expansion we have had in the last couple of years, but some important industries are operating at a lower level now, or at about as low a level as they operated at 3 or 4 years ago. That is true of a lot of machinery producers—Caterpillar tractors, machine tool producers; the steel industry has not done, as you know, at all well; those people are directly, adversely affected.

At the same time, there is ready availability of goods from abroad which, of course, the consumer loves, and it keeps our economy very competitive, and keeps pressure on prices. And I think it has been an important factor in the degree of progress that we have made on the price side. As that progress is built in, and reflected in wage-bargaining behavior and pricing policies and competition, it has helped give us an impetus toward price stability that is favorable.

Looking at it in a worldwide perspective, you have to realize that that big increase in our trade deficit has probably been the biggest single factor which has accounted for some growth in the rest of the world, which is, in turn, of some importance to us. It is not a happy thing that they have had to rely on our deficits to grow, but it is better than if they were not growing at all.

CANNOT HAVE CAPITAL INFLOW WITHOUT TRADE DEFICIT

The ultimate difficulty, in my judgment, is it is simply not sustainable, and for all the pluses and minuses at the moment, I do not think we want to build our future economy on the prospect of a capital inflow. You cannot have the capital inflow without the trade deficit that at some point is going to let us down. The inflow is not going to continue forever. I have no projection, no feeling, as to how long it could be sustained. We are so strong as a starting point; the feelings of confidence in the United States are strong enough that maybe it can continue for a while—for quite a while. But we had better take advantage of this opportunity to get our own house in order so we do not have to live with that capital outflow forever. I think that is what this deficit question is all about:

Can we take advantage of this opportunity to get our own house in shape so that we are not relying upon that capital inflow?

Senator SASSER. Well, Mr. Chairman, under the President's budget which has been submitted, it projects according to consensus economics here, a $178 billion deficit in fiscal year 1976——

Mr. VOLCKER. With the cuts.

Senator SASSER [continuing]. With the cuts, yes—$171 billion in 1987, with the cuts; $167 billion in 1988 with the cuts. Are those cuts—will that budget with the cuts, Mr. Chairman, be sufficient to set our economic house in order and to start bringing the value of the dollar down to some extent?

Mr. VOLCKER. Not in and of itself, necessarily, but I think it would be a good start. Then you go back and look at it in subsequent years and see how things are developing. I am not going to guarantee you that is all you have to do, by any means. But looking at what is needed now, and what the practical possibilities would be now, it would be a good start. You are going to be back here next year, I presume, and you can look at it again.

ECONOMIC DIFFERENCES BETWEEN DEFENSE AND SOCIAL SPENDING CUTS

Senator SASSER. One final question, Mr. Chairman, and then I will stop. Mr. Volcker, yesterday, the Secretary of Defense, Mr. Weinberger, testified before this committee that a dollar that is cut from the defense budget did not necessarily transcend into a dollar reduction from the deficit. He seemed to be taking the attitude that there was a difference between a dollar cut from the defense budget and a dollar cut from social spending, as it affects the deficit and as it has overall budget implication.

Could you outline for us the economic differences, if any, between defense spending cuts and social spending cuts, in strict budgetary terms?

Mr. VOLCKER. I think there could be differences in particular instances, but I doubt those differences are big enough to be significant to you in making any budgetary decision. The principal difference, I think, would not be between defense and civilian expenditures, but between expenditures that might lead to further rounds of rather direct investment in the private economy—which might be true of some defense programs during a buildup stage—and an expenditures that led to generalized consumption, including some imports. I think those are second-order differences beyond the degree of refinement that you need in determining budgetary policy; I would think they are fairly irrelevant.

Senator SASSER. So in your judgment, it is irrelevant. A cut made in the defense dollar would be just as effective in reducing the deficit as a cut made in other spending programs.

Mr. VOLCKER. I think it would be close enough, without being specific about some particular area of cuts where it might be different—yes, I do.

Senator SASSER. Thank you, Mr. Chairman.

[Whereupon, Senator Domenici resumed the Chair.]

Chairman DOMENICI. Senator Chiles.

RECESSION SCENARIO WITH DEFICITS 3 TO 5 PERCENT OF GNP

Senator CHILES. Mr. Chairman, I just wonder if you could give us any idea of where you think we might be if one of the worst scenarios happened, and we were to have a recession between now and 1990, when the deficits were in the neighborhood of $170 billion or higher. What would that do to us, if we went into a recession with deficits in the neighborhood of 3 to 5 percent of our GNP?

Mr. VOLCKER. Frankly, Senator, that does not worry me as much as some other scenarios. Obviously, if we have a recession during that period—and indeed, in historical experience, it would be very unusual if you did not; this recovery began in late 1982, and to go through 1990 without a recession, might make the only time in history that we have gone that long without a recession, or a close second, anyway—the impact of that recession on revenues and expenditures would typically be accompanied by less private investment. That is what a recession is all about. That is why you have the recession and, therefore, it is much easier to finance a deficit under those circumstances.

I am not arguing that it is not alarming and troublesome to have a deficit soaring to $300 billion or above—whatever the numbers would show—if you do not do anything on the underlying deficit. But I worry less about that than the economy moving along at a good clip, with a degree of pressure on resources, including financial resources reflected in interest rates. We are counting on this flow of savings from abroad that comes very easily. If it drops off, what happens? That is the kind of event that could precipitate that recession, through its financial market consequences.

I would worry at that earlier stage about the events that might grow out of the combination of high deficits and other factors that would precipitate the recession prematurely, before I worried about the recession itself; I think we are in jeopardy of that kind of difficulty.

That is, in modified form, anyway, the difficulty that this economic forecast I earlier saw.

DOLLAR DOWN AS A RESULT OF LOSS OF CONFIDENCE

Senator CHILES. I have heard you discuss before, but I think it might be good if we had it for our record here now, your feeling that if the dollar fell as a result of a rapid loss of confidence on the part of our foreign investors what pressures would come to bear. What does that do to inflation?

Mr. VOLCKER. It tends to put inflation and interest rates up, in some combination. Let me put it this way. There is no way on Earth, as things now stand, that we do not have to borrow a lot of money abroad, because our trade deficit is going to remain for a while. It does not change very rapidly. Given that fact, we are going to have to borrow abroad. The only question is the terms and conditions under which we borrow, and the terms and conditions have two main dimensions—the exchange rate and the interest rate. Both would be under pressure, presumably, in those circumstances, and the interest rate pressure is compounded by the inflationary effects of the decline in the exchange rate as that feeds back in the domestic inflationary situation. You have a potential for real problems in the financial markets under those circumstances.

You have a quite different situation, in my judgment, if you do what I would urge, and take action on the budget to reduce our financial dependence on those foreign savings. Then the dollar might go down, but it would presumably go down in a more orderly way, and we could get along without all that capital inflow, because we do not need it to finance the Government, in effect. That is a much more constructive scenario, and your action in doing that will maintain the confidence to keep the capital coming in in the amounts that we need.

Senator CHILES. Even though the dollar has gone down, and even though the interest rate is down——

Mr. VOLCKER. Even if the dollar is going down, you do not have that risk of a lack of confidence, an abrupt, falling, a bottomless pit feeling—because you would have maintained the confidence.

Senator CHILES. Thank you.

Chairman DOMENICI. Senator Exon, did you have any further questions?

Senator EXON. I have two questions, Mr. Chairman, and I do not think they will take very long.

Chairman DOMENICI. Please.

ZERO DEFICIT IN NEXT FEW YEARS

Senator EXON. Mr. Chairman, this is an if-fy question, but I just wanted to get some general direction from you, for those of us who are continuing to struggle to get this deficit down.

Under a reasonable scenario of growth in the future, and under a reasonable scenario of no deep recession, how much of a deficit do you think we could conveniently live with in each year of the next 5 years—zero, or—zero would be best, but——

Mr. VOLCKER. I would love to get down to zero, but I cannot answer your question more precisely than that. It is so far below, where we are, that it is not a practical consideration in your thinking now. You can do all you can do now in these amounts that we are talking about, and there is no risk that you are going to reduce the deficit so far that it is going to be below some optimum point, in my judgment.

Senator EXON. You do not think that is a concern.

Mr. VOLCKER. I do not think that is a concern that has to be in your mind this year. I would love for you to get the budget in a condition where that is a legitimate concern 2 or 3 years down the road, but I do not think it is a concern now.

Senator EXON. Well, I understand your answer to the question. I do think, though, very sincerely, that there have been many of us or all of us who have tried to work out a realistic position of some kind—in other words, the President is saying his goal is to get the deficit under $100 billion when he leaves office. Let me ask you this question. If we can get down to that figure, would you think that at least that would be something that we might be able to live with?

Mr. VOLCKER. You could live with it easier than you can live with $250 billion; that is a big difference. But if you are looking for a long-term goal, I will stick to the good old notion that in a prosperous economy, the Federal budget ought to be balanced, or better than balanced. We ought to repay a little debt. That ought to be the long-term goal.

ENHANCE REVENUE WITH MINIMUM TAX OR CLOSE LOOPHOLES

Senator **Exon**. One last question, Mr. Chairman. In our struggle to cut these deficits, primarily by cutting expenditures, which I think we all agree with, in your opinion, could we enhance revenue from the corporations of America somewhat by a minimum tax or closing loopholes or something of that nature without, in your opinion, doing danger or killing the golden goose that is laying both fertile and unfertile golden eggs in abundance these days?

Mr. **Volcker**. I think, again, from the economic standpoint, the emphasis is better placed on expenditures, but I am not going to say that any tax increase through a loophole closing or of other sorts is inconsistent with growth and, to the extent it contributes toward reducing the deficit, I think it helps to reinforce growth.

Senator **Exon**. Thank you, Mr. Chairman.

GROWING OUT OF DEFICIT NOT ENOUGH

Chairman **Domenici**. Mr. Chairman, I assume in my absence, you were asked one way or the other whether the American economy could grow its way out of this deficit.

Mr. **Volcker**. Yes.

Chairman **Domenici**. I assume you said that you did not think we could?

Mr. **Volcker**. Not without some help on your part. I said that if you give it enough impetus in the beginning, growth can come along and help. Obviously, growth is important, but I have not seen a forecast or an analysis that says it is plausible to just sit back and saying we are going to grow our way out.

Chairman **Domenici**. It appears to me that one of the real problems we have, Chairman Volcker, is that there is a lot of optimism out there because the economic facts of life are that things are pretty good. You are absolutely right, there are some spotty areas that are very fragile and in serious condition, but my experience in my State and around the country, just coming off the campaign, clearly, the people are very optimistic. That makes it very difficult to suggest that they ought to take a big dose of medicine and some real sacrifice.

But if I understood your testimony correctly, what you are saying is that is exactly the time we had better do it——

Mr. **Volcker**. Precisely.

Chairman **Domenici** [continuing]. Because if we wait around until things are worse, we might not be able to do any of the things we have to do.

Is that basically it?

Mr. **Volcker**. That is basically it. I think there are enough warning signs, very serious warning signs, of difficulties and imbalances, that we cannot say that we do not have all the signals that are necessary, even given—and I recognize the difficulties that that creates—the general feeling that things are going well. They are going well, partly on the basis of something that cannot last.

STATES AND LOCALITIES IN BETTER FISCAL POSITION

Chairman **Domenici**. Mr. Chairman, this might be a question that you do not have information on. On the other hand, I would assume, considering the broad nature of your mission, that you might, so I will ask it.

A number of the programs recommended for termination reform or substantial cuts are in the area of revenue-sharing; cities and States presently get mass transit subsidy money from us, they presently get UDAG grants and the like. You add it all the cuts up, and clearly, there will be a substantial impact upon the current operations of the municipalities and similar entities, in any budget package you look at that is reasonable.

It is being said, however, that the cities are in reasonably good shape and that they might even be more fit to take some of these cuts than their National Government.

Do you have an assessment of that?

Chairman **Volcker**. I think all I can say is that the overall figures would show States and localities are in a better fiscal position now than they probably have been in some time. But many of these localities did increase taxes and reduce expenditures rather sharply a few years ago, and they are now feeling the fruits of that. They are feeling the fruits of their tough budgetary measures earlier. As a result, they are in a better fiscal position, but I am sure many of them would like to revert to the tax levels that they had earlier and make up for some of the expenditure reductions they made. The fiscal position as a whole is stronger than it has been.

AGRICULTURAL BELT BANKING SYSTEM

Chairman **Domenici**. My last question—and if it has been asked already, let me know—is in reference to the banking system in the agricultural belt. Senator Exon asked how bad off it really is, in terms of——

Senator **Exon**. Well, I think we covered it in quite a lot of detail, Mr. Chairman, but ask it again——

Chairman **Domenici**. Well, frankly, you know, I am sympathetic. Obviously, I am one who thinks we have got to reform the programs that are costing us money. I think we have to reform them rather dramatically, by looking at the history of how much we have spent and what that spending has or has not accomplished. But any time that topic comes up, you hear contentions at least of a regional nature that the lending portfolio of many of the banks, including a couple of central banks, one in middle America and one over on the west coast, are in pretty bad shape, and that we had better do something to alleviate the banks' troubles before we consider reducing the loan rates, subsidies, and cost items.

Could you give us an assessment of that?

Mr. **Volcker**. My general assessment, which did come up earlier, is that we are fortunate that these lending institutions, whether they are the private banks or the Farm Credit Administration, have been quite profitable in the past, and they are strongly capitalized. There is no question that there are strains and pressures out there, and there are going to be loan losses, and sizable loan losses; we have a cushion, and it is a happy circumstance that we have that cushion. There were more failures of agricultural banks last year—and it tended to go up during the year—and I am sure we are going to see more. Those banks, from the depositors' side, are largely fully insured, so that that is one factor which reduces the disturbances arising from that situation.

The problem, I think, centers largely on the fact that while it is manageable in terms of the total banking system, local communities are relying on these local banks; they need banking services and, in some cases, it may be more difficult than in the past to maintain those local outlets for banking services.

BANK FAILURES

Chairman DOMENICI. Well, how many banks in the last 4 years have stopped operating because of bankruptcy and the like, in the exact form that they were and changed to something else? There have been a lot in the last 4 years, haven't there?

Mr. VOLCKER. I do not remember the figure for the last 4 years. It has been mounting. As I recall, there were about 80 or so bank failures last year, which is the highest we have had for some time, and a growing fraction of those through the year, were agricultural banks.

I guessed at 80, I have been given the figure of 79, of which 29 were arbitrarily classified as agricultural banks.

Chairman DOMENICI. The Senator from Florida just said that one went today, and so he is right and you are right.

Mr. VOLCKER. So you were right. [Laughter.]

I do not have a list of how many of those were taken over by other banks, whether the offices and the services were maintained. I would think that happened in most cases; I am sure it happened in a great majority of cases. But in some of these agricultural areas—and it may be increasingly true, particularly in the present conditions—the location does not appear attractive enough for another to want to come in and take over, even if the institution is getting the bank, in effect, for free, with good assets.

You are going to run into increasing problems where a failure of an agricultural bank means a failure of local banking services in that particular town. People will be inconvenienced, to say the least; it is more serious than that for the local borrower, who is dependent upon a local source of credit.

Chairman DOMENICI. But there has been a propensity on the part of banks to want to take over other banks, merge and the like——

Mr. VOLCKER. That is the typical pattern, yes.

Chairman DOMENICI. I have no further questions.

Senator BOSCHWITZ. This guarantee package that was just put together specifically addressed that, too, as you know, Mr. Chairman, and I think it will ease that particular problem.

Chairman DOMENICI. Senator Exon.

NEW BANKS HAVE CONSERVATIVE LENDING APPROACH

Senator EXON. Let me just add to that maybe a matter of clarification—I am sure that Chairman Volcker knows this. But in many, many instances in Nebraska, for example, even when a bank has come in and taken over in a particular situation, it was thought that that would solve the problem. The difficulty is what the Chairman alluded to. Many times, even when a bank is taken over, and then still have a bank in that particular community, the new bank is so conservative in their approach, and have thrown out anything that is the least bit questionable, that they are so conservative in their lending policies—which they have to be with the declining assets that the farmers are experiencing today—that they do not provide effectively the function of a bank that we traditionally expect in a certain area. I mean, there is an extreme tightening out there today, some of it justified, in my opinion, some of it not.

Is that a fair explanation of the situation, in some instances, Mr. Chairman?

Mr. VOLCKER. I think that problem could arise, although if a bank wants to go in that area, the only reason for going is to provide services to the community, which it has got to do by lending. You have the problem, which many people have commented on, that the new bank will not take over the questionable loans; they are left with the FDIC, and the FDIC is not a lending organization, but a liquidation organization.

Senator EXON. We have experienced that.

Mr. VOLCKER. And that obviously does not make it any easier; that is the nature of the difficulty.

Senator EXON. One last comment I would like to make, and I do not know what you care to say about this. I have heard, and maybe I have heard incorrectly, that a sizable remaining portion of the portfolio of troubled Continental of Illinois National Bank is in agriculture, maybe, possibly, to a percentage extent, more than would be considered healthy under present circumstances.

Is that necessarily true?

Mr. VOLCKER. I simply do not know the answer to that question. It does not accord with my impression.

Senator EXON. Thank you.

Chairman DOMENICI. Anything further?

Senator EXON. No, Mr. Chairman.

Chairman DOMENICI. Thank you, Senator Exon.

Thank you very much, Mr. Chairman.

[Whereupon, at 11:01 a.m., the committee was adjourned.]

VIEWS OF THE REAGAN ADMINISTRATION

WEDNESDAY, FEBRUARY 20, 1985

U.S. Senate,
Committee on the Budget,
Washington, DC.

The committee met, pursuant to notice, at 2:45 p.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Kasten, Gorton, Chiles, Hollings, Johnston, Sasser, Metzenbaum, Riegle, and Moynihan.

Staff present: Stephen Bell, staff director; and Gail Fosler, chief economist.

For the minority: Richard N. Brandon, staff director; and John Hilley, senior economist.

Chairman **Domenici**. We are going to reconvene.

Senator Chiles, I wonder if, in the interest of time, we all might waive our opening remarks and let the Secretary start.

Senator **Chiles**. I had a pretty good opening statement here. [Laughter.] I do not know whether you are prepared or not.

Chairman **Domenici**. I have a great one. [Laughter.] If I can waive mine, you can sure waive yours.

Senator **Chiles**. Yes.

Chairman **Domenici**. Let us proceed on that basis, and I am sure we can work some of our remarks in our questioning.

We probably will stray a little bit from questions aimed soley at the Secretary of the Treasury, because we know you have been part of putting together the budget over many, many months, and a number of the Senators may want to ask about that.

If you have a prepared statement, we will make it a part of the record. You can either read it or abbreviate it at your pleasure. However, we do not have a lot of time, and we have a number of Senators that would like to ask questions.

Welcome. It is your first appearance before us. It is not, however, your first appearance before a committee up on the Hill. You have been through it a few times, and we are delighted to have you before the Budget Committee.

Mr. Secretary, please proceed.

STATEMENT OF HON. JAMES A. BAKER, SECRETARY OF THE TREASURY

Secretary **Baker**. Thank you, Mr. Chairman. I will simply ask that you insert my statement into the record, if that is all right, although I would like to read an insert into the printed statement that I furnished the committee, and the insert begins on page 4 of my submitted testimony immediately following the sentence that says, "This would leave a deficit of less than $100 billion by 1990."

Dealing with the deficits is going to require tough decisions but we have to face up to them. A case in point is the revenue-sharing program which is run by the Treasury Department and would be eliminated under our budget proposal. Revenue sharing has been a relatively efficient, well-run program, but with current service deficits exceeding $200 billion, the Federal Government can no longer afford revenue sharing. Simply stated, we have no revenue to share. I have no doubt that there will be substantial resistance to this and every other deficit reduction measure proposal in our budget, but if we are serious about achieving our goal of deficit reduction, we have to face up to the fundamental fact that we can no longer afford to continue to allow total Federal spending to grow.

And I ask that that be taken as an insert to my statement, Mr. Chairman.

Chairman DOMENICI. Without objection, the statement will be made part of the record.

[The prepared statement of Secretary Baker follows:]

Testimony of the Honorable
James A. Baker, III
Secretary of the Treasury
Before the U.S. Senate Committee on the Budget
February 20, 1985

Mr. Chairman and Members of the Committee:

It is a pleasure to meet with you today to discuss our fiscal affairs and the tasks that lie ahead. The economy has done very well in the past year and the outlook for the future is promising. But we are faced with the need to reduce what has become an excessive rate of Federal spending. Because of that Federal spending, the prospective budget deficits that would develop in the absence of any offsetting action are far too large for our long-run economic health. We must place the Federal budget deficit on a declining path and keep it there. With your help and a bipartisan Congressional effort, I am sure that meaningful reductions in the growth of Federal spending can be achieved. Legislative action along the lines recommended in the President's Budget proposals will provide a fiscal framework within which the economy can continue to prosper.

These past four years have been marked by truly dramatic improvement in the performance of the U. S. economy. Four years ago, it was the increasingly held belief that we had lost the ability to control our economic destiny -- that inflation was out of control, that dwindling availability of natural resources would put a cap on growth; and, most worrisome of all, we were told that we had lost the innovative spirit that had propelled this economy to world leadership.

Now, confidence in our ability to meet the challenges of the future is being restored by the implementation of an economic program designed specifically to:

-- bring inflation under control,

- -- free markets from the burden of unnecessary government interference,
- -- restore incentives for productivity and growth,
- -- and, thereby, increase opportunity for all.

That program has been remarkably successful by almost every measure of economic performance.

- -- Real growth for 1984 was the highest since 1951. During the first two years of the current expansion, at a 6.0 percent annual rate, real growth has been the strongest for any expansion since the economy pulled out of the strike-depressed recession trough of late-1949 into the Korean War boom.
- -- Growth of real business capital spending during this expansion has far outpaced gains during any previous postwar recovery.
- -- Our economy has shown itself to be a remarkable job-creating machine. Spurred by formation of new business and by technological innovation, more than 7.3 million jobs have been created during this recovery and expansion.
- -- And even as the economy has shown this remarkable growth, inflation has stayed under control. For each of the past three years, it has not exceeded 4%. Last year, as measured by the GNP deflator, it was the lowest since 1967. And the trends of wages, oil prices, and world raw material prices all remain favorable.

I have made a promise to myself that I know I may not be able to keep. But I shall try. While I will of course contribute to the development of economic forecasts that we use for purposes of planning and analysis, I shall try to resist the temptation to offer specific, detailed, numerical economic forecasts of my own.

The economic projections underlying the budget assume continued real economic growth and a steady decline in unemployment, inflation, and interest rates.

Consistent with my promise to myself, let me say only this about the overall economic outlook. Prospects are excellent for sustained economic growth without inflation -- provided that we act promptly and responsibly to continue what we have begun. And by "we" I should emphasize that I mean to include both Houses of the Congress, as well as the Executive Branch.

There is still much unfinished business.

We must not rest with the tax rate reduction we enacted in 1981. That simply adjusted for the hyper-inflation that the economy had been experiencing before. Now we must go on, as the President has directed, to overhaul the whole tax system -- to increase fairness, simplicity, and economic growth. This element of our program is, as the President has said, of equal priority with spending control.

The printed budget document includes a number of revenue-related measures -- most of which have been submitted before. These range from tuition tax credits to enterprize zone incentives to technical provisions related to certain trust funds. The budget does not include the proposals for comprehensive overhaul of the tax system -- for, as you know, those proposals, made public on November 27, remain under review. But we believe that -- with constructive effort by all parties -- a comprehensive restructuring of the tax system could be enacted this year. And I will be having a good deal more to say about this in other contexts.

The focus of today's discussion is principally upon our printed budget, however.

Immediate steps must be taken to narrow the deficit.

Just as important as closing the deficit is the manner by which it is closed. It would be wrong to go back to our old ways of pushing up taxes, either legislatively or by bracket creep in a nonindexed system. In our view, the tax reductions of the past several years have been largely responsible for the turnaround in economic performance. This means that deficit reduction must be accomplished from the spending side.

The large deficits that we face during the remainder of the decade are due to an excessive rate of Federal spending. The American people do not feel they are undertaxed. They want government spending brought under control.

Between 1964 and 1979, Federal outlays averaged 20-1/2 percent of GNP. Now they are in the 24 to 25 percent range. Federal outlays have virtually been living a life of their own. The President's budget proposals would restrain the rate of growth of outlays below that of the economy and shrink the outlay-GNP ratio down to the 21 percent range by the end of the decade. This would leave a deficit of less than $100 billion by 1990.

The President's budget proposes a combination of freezes, reforms, user fees, program cuts and terminations that will achieve savings for fiscal year 1986 of a little more than $50 billion. This is calculated from the "baseline" path that spending would take if we did nothing. These reductions are sufficient to hold total spending on government programs -- that is, everything but debt service -- no higher in 1986 than in 1985. It is an ambitious target, but is achievable, without damaging the social safety net, or our continued defense rebuilding, or any essential government function.

Achievement of our target of $50 billion in reductions would accomplish two things. The deficit in 1986 would be about $40 billion less than in 1985. And, even more important, the actions taken this year will have an amplified effect in later years, resulting in annual savings of more than $100 billion by 1988. This will set the deficit on a declining path -- both in absolute dollars and, even more significantly, as a share of GNP. Under our economic assumptions, the deficit would drop from over 5 1/2 percent of GNP this year to less than 3 percent by 1988 -- on down to less than 1 1/2 percent by 1990. The exact percentages are not the issue; the important thing is the trend.

The deficit has been accommodated thus far without damage to the expansion, and interest rates have declined considerably. But "real" interest rates remain too high. We need monetary policies that will allow us to continue strong economic growth without inflation. Such policies will help get interest rates down further. At the same time, a firm, convincing policy of deficit reduction will also help keep us on a course to still lower interest rates -- while insuring that the Government, in financing the deficit, does not absorb such a large share of the nation's savings as to impair private productive investment.

Our budget proposal represents a "freeze" in total program spending. That is something that is easy for most to understand -- and to most, I think, it makes sense. There will, we know, be disagreements about what we propose specifically for one program or another. But we believe our specific proposals are thoroughly defensible on the merits. And we look forward to working with the Congress to develop a comprehensive package that will bring the budget under control -- by freezing overall program spending for fiscal year 1986.

With good will, we believe this can be done. We are sure it is what the American people want to be done.

ECONOMY INVIGORATED

Secretary **Baker**. Beyond that, if I may just say the following. I would like to read, if I might, two paragraphs from the President's State of the Union wherein he said:

> Four years ago, we said we would invigorate our economy by giving people greater freedom and incentives to take risks and letting them keep more of what they earn.
>
> We did what we promised and a great industrial giant is reborn. Tonight we can take pride in 25 straight months of economic growth, the strongest in 34 years, a three year inflation average of 3.9 percent, the lowest in 17 years, and 7.3 million new jobs in two years with more of our citizens working than ever before.

Mr. Chairman, I think this economic growth can continue if the Congress can enact the President's spending cuts or spending control and if the Federal Reserve will pursue monetary policies which will permit us to enjoy sustained economic growth without inflation.

Thank you very much.

Chairman **Domenici**. Thank you, Mr. Secretary.

Senator Chiles.

BIPARTISAN TAX REFORM PROGRAM

Senator **Chiles**. Mr. Secretary, I listened to the President's State of the Union address myself and I heard him mention the Treasury study. But then I heard him say that he was going to send you as the Secretary of Treasury to the Congress to work out a bipartisan Tax-Reform Program.

A lot of us are trying to figure out whether the President has a plan. We know that we had the plan that came out of Treasury. Now, I notice that the President in an article in the Wall Street Journal talked about problems he found with that study. On the other hand, he has praised the study. Now he says he is sending you with a bipartisan plan.

Does the President have a plan or is he going to wait until Congress has a plan or one materializes?

Secretary **Baker**. Senator, the President would like to develop a plan for tax reform in conjunction with the tax writing committees and congressional authors. As I said before, this is a rather ambitious undertaking, and I think it is the President's view as expressed in the State of the Union address that it is not going to be done without a considerable amount of goodwill and bipartisan support from both sides.

So there is no plan in existence today that the President has embraced or endorsed. He sees, and we see, the Treasury Department proposal as a starting point. We want to take the proposal and, again, working with the revelant committees of the Congress and with congressional authors, see if we can develop bipartisan support for tax reform which we think is a worthy goal in and of itself.

CORPORATE TAX STRUCTURE

Senator **Chiles**. Well, I notice that the President says that he is all for tax simplification and reducing the individual tax rates. At the same time, he has said that he has some concerns about the changes in the corporate tax structure that are proposed in the Treasury plan.

Secretary **Baker**. I think what he said, Senator, if I may——

Senator **Chiles**. Excuse me. Just to get to the question, if we do not do something about the corporate tax structure and the provisions that are there now for the tax expenditures and the loopholes, how can we reduce the individual tax rate?

Secretary **Baker**. Well, it involves a balancing of equities and a balancing of competing claims. I think if, again, you look at what the President said in the State of the Union, address, you will see that he said he'd like to do this in a way that would maintain incentives for capital formation. I know that is what he said in the Wall Street Journal article, and I know that that is his position.

I think what he is saying is we cannot just look at one side of this equation. We cannot say simply we want to reduce individual rates, and therefore, we are going to take it out of the capital formation side.

We have to do it in a way that does not destroy incentives and destroy capital formation, and frankly, putting together such a package is our job.

Senator **Chiles**. Well, when we look now and see overall what the corporation rate is, we see that over the last few years in 1965 corporate taxes as a percentage of total revenues was 22 percent. By 1983 that figure was down to 6.2 percent.

In 1970 the corporate tax level as a percentage of corporate profits was nearly 46 percent. By 1983, it was down to 16 percent. Now we have corporations paying no taxes that are major earners and are making tremendous profits. Yet we have small- and middle-class corporations paying the maximum rate.

Can we really allow that to continue that way? Is that tax fairness?

Secretary **Baker**. I do not think so, Senator, and I stated so yesterday. It seems to me that a situation where there are major corporations that year after year generate significant income and yet pay no taxes is, frankly, one of the vices that tax reform would seek to correct.

REDUCE DEFICIT TO 2 PERCENT OF GNP

Senator **Chiles**. I understand the President thinks tax reform is just as important as deficit reduction, but it is going to be on another track. We are going to have deficit reduction first, and then we can talk about tax reform.

I have been trying to determine how we can cut from 5 percent of the GNP a negative 5 percent down to 2 percent to get the deficit under $100 billion at the end of about 3 years which was Mr. Stockman's theses.

I have not been able to come up with any cuts I could propose if I were king that could get it down that low. So it seems to me we have to talk about some revenue.

Why in the world when we are talking about asking people to bear pain and we are saying to groups from senior citizens to retirees to Government workers to the WIC Program for childhood nutrition feeding that everybody is going to have to bear some pain, but we are not going to talk about these people that do not pay their fair share of the taxes now as bearing pain.

LOOK AT TAX EXPENDITURES

What is the difference between a tax expenditure and any other sort of government program we have? We are treating a segment of our society different from others. If we are really serious about this deficit, why are we not talking about some of those tax expenditures and saying we are going to put that with the spending cuts we make to really do this job? The basis on which I try to talk to my senior citizens, for example, is look, are you willing to bear part of your share of this pain in a COLA adjustment if necessary if we can convince you that it is going to be fair and we are going to get the deficit down.

They say two things. They say we want to know everybody is going to bear their fair share including individuals and corporations who are not, and also we want to know that you can guarantee us that that interest rate is going to come down.

The only way we can do that, as I see it, is to really reduce this to below 2 percent of GNP. Can we do that without any revenues and why should we not be talking about some of those revenues now?

Secretary **Baker**. Senator, I would like to argue that we could hopefully see some action as far as interest rates are concerned if we put the deficit on a path that would get us down to that 2-percent level. The President has submitted a budget that would do that.

Now, I do not argue with you. I cannot debate the proposition that it takes a great deal of political courage. and political will to do the kind of cutting that the President is suggesting, but he is going to stand behind that budget. He is going to lead the charge for that budget.

It seems to me that this last——

PRESIDENT NOT LEADING ON COLA CUTS

Senator **Chiles**. I had not seen him leading on those COLA cuts.

Secretary **Baker**. Are you talking about the COLA reductions that are in the budget he submitted?

Senator **Chiles**. I am talking about across the board.

Secretary **Baker**. Well, that is not in his budget.

Senator **Chiles**. Oh, I see.

Secretary **Baker**. What he will lead the charge on is the budget.

Senator **Chiles**. He is going to stand way behind that one, is he not?

Secretary **Baker**. No, he determined that he was not going to consider eliminating the cost-of-living increase for Social Security recipients and SSI recipients.

Senator **Chiles**. Well, how do I look to a person that is drawing a pension and say I am going to cut your COLA, and the President is standing behind me on that, but we are not going to cut a person who is retired and perhaps has a tremendous amount of earnings but they are on Social Security. We are not going to cut your COLA.

Secretary **Baker**. The only answer I can give to that, Senator, is that the budget exercise involves those choices every year, and you make them up here every year before this committee. You have to pick and choose between programs that you are going to increase and programs that you are going to reduce.

So that would be my answer, and the answer to why we are not going with revenues——

Senator **Chiles**. Not very satisfactory, Mr. Baker.

INCREASING REVENUES WILL NOT REDUCE DEFICIT

Secretary **Baker**. Well, I think that is what the President's position is. As far as revenue is concerned, Senator, it is his view and our view that the minute we start a debate on increasing revenues, we will really have difficult time finding the political will to eliminate or to reduce the deficit on the spending side.

If this last national election told us anything, I think it told us that the American people want the deficit reduced, but they do not want it redcced through tax increases. So that is why he submitted a budget that calls for some rather courageous political acts.

LOOPHOLE CLOSINGS NOT EQUATED WITH TAX INCREASE

Senator **Chiles**. Do you not think that when you say tax increase to the American people what that says to them is that you are going to increase my taxes? When I go and talk to an audience and I ask them whether they sort of think if General Electric was to pay a little taxes on their corporation, whether they think that is a tax increase on them, I do not find that they feel that.

When I talk to them about a loophole that is allowing somebody not even pay any kind of tax that has tremendous income, I do not think they equate that with what we call a tax increase.

Secretary **Baker**. We have used all sorts of terms down there as I suppose you have up here. Loophole closing and revenue enhancement and all the rest of it.

Senator **Chiles**. You got away with it pretty good the last 2 years, have you not?

Secretary **Baker**. That is right, and we raised revenue over the course of the past 3 years, I think, substantially. But let me just tell you that it is the President's strongly held view that anything like that, loophole closings, revenue enhancement, call it what you will, it is tax increase.

Chairman **Domenici**. Senator Metzenbaum.

STRENGTHEN MINIMUM CORPORATE TAX

Senator **Metzenbaum**. Secretary Baker, I am angry and I am frustrated because honestly I do not know where the President stands, and I do not think the American people do. He did get elected by an overwhelming margin. He said at one point, "When are we all going to have the courage to point out that in our tax structure the existence of corporate tax is very hard to justify.

That means he is against corporate taxes. But, on January 28, 1982, he said, "We intend to plug unwarranted tax loopholes and strengthen the law which requires all large corporations to pay a minimum tax."

That is 100 percent the opposite of what he said previously. On February 8, 1982, he said, "That does not mean unintended loopholes should go uncorrected, that obsolete tax incentives should be continued or that profitable business should not contribute at least some minimum fair share to the cost of financing government. Thus our deficit reduction plan includes $34 billion over the next 3 years in addition to receipts from new initiatives in these areas. About one-third of this total is attributable to our proposal to strengthen the minimum corporate tax."

Then he went on to say that we have to take care of the loopholes as well as of the other two thirds. Frankly, he said, "There ought not be any corporate taxes." Then he said, "We ought to have a minimum tax."

I went to the floor with a proposed minimum tax, and you never saw so many Senators who had written the President including 18 on that side of the aisle who had written him, and said it is an abomination that corporations are not paying any taxes and we did not know that by 1985 50 percent of them would be paying no taxes, run away from the bill although that is exactly what has happened. The administration is not to be found. The great lobbying effort is not there.

Frankly, Mr. Secretary, I think the President has a responsibility to lead. Now, he has a right to say he is for minimum taxes or against it. He has the right to say he is for corporations paying a fair share of taxes or he is not.

But I do not believe that he can meet his responsibilities as the President of the United States and duck this issue. And I do not think he can do it by saying we are going to have to look at it. He is asking us to act and we are prepared to act; 535 Members of Congress were willing to act to do something about the budget deficit, but it is high time that the President not duck behind Mr. Regan and say that is his program and mine and then have Mr. Regan go on the TV and say, "Well, I am the administration."

Where are we?

PRESIDENT NOT DUCKING TAX REFORM

Secretary Baker. Senator, I do not think you will see the President ducking on tax reform because after all he put it first in his State of the Union address.

Senator Metzenbaum. Send us a bill.

Secretary Baker. And he has said on repeated occasions that it constitutes an equal priority in his mind with deficit reduction, and he has said it is his fervent hope that we will have a tax reform proposal this year.

It is, after all, a rather ambitious undertaking. I have just told Senator Chiles that corporations that pay no income taxes are one of the things that ought to be taken care of in any reform of the Tax Code.

Senator Metzenbaum. Well, will you support a minimum tax for corporations along the lines of exactly what the President said, 15 percent over $50,000?

Secretary Baker. No, sir. I am not prepared to accept any——

Senator Metzenbaum. That was the President's statement. That is what he said.

Secretary **Baker**. In the context of a different budget year, and a different legislative proposal.

Senator **Metzenbaum**. It is worse not better.

BIPARTISAN SUPPORT NEEDED FOR TAX REFORM

Secretary **Baker**. But what the President would like us to do on the revenue side, Senator, is take a look at the possibility of overall reform of our Tax Code so that we can cure the kind of problems that you and Senator Chiles are talking about, and one of those problems is corporations that do not pay any income tax.

You will see the President leading the charge if we get close enough, if we can find bipartisan support for an overall——

Senator **Metzenbaum**. Why bipartisan support? Why cannot you come forward with a program of your own? You are the President. You speak for the President. We look to the Treasury for leadership. This bipartisan support, you just saying let the Democrats get into the ball game, is ducking.

Secretary **Baker**. Senator, if I may respectfully disagree, I think it is not unlike the situation we faced with respect to Social Security. That is a major, major undertaking with considerable political volatility. So is this.

There was no chance at all that there would be a Social Security compromise except for the fact that Senator Moynihan and Senator Domenici and Senator Dole and a number of other people were willing to sit down with us and the Speaker's representative, and hammer out a very tough solution to a very tough problem. This is the same kind of a situation.

If we are going to get tax reform, it is going to have to be done on a bipartisan basis. The President, I would suggest to you, sir, respectfully, is leading by sending you a budget which he is going to stand behind and which he is going to go out and fight for.

Senator **Metzenbaum**. Sure, and you are meeting with the corporate lobbyist to see how you will change Mr. Regan's program, the Regan tax proposal. We do not know where you stand. We do not know which issue we can move in on in order to find the money. We have a responsibility as the Budget Committee to try to balance the budget or to move in that direction.

Secretary **Baker**. Senator, if I may say so, one of the things the President has said is that tax reform is a major undertaking, a very worthy goal, and we ought not to do it in the context of deficit reduction. We ought to do it outside of that context. In his view, it should be revenue neutral.

In fact, he said he wanted it to be revenue neutral and not a means of getting the budget deficit down.

Chairman **Domenici**. Senator, your time has expired.

Senator Moynihan.

Senator **Moynihan**. Thank you, Mr. Chairman.

Mr. Secretary. I welcome you before this body in your first appearance, I believe, as the Secretary of the Treasury. How does it feel to be free? You sometimes wish you were back behind bars.

Secretary **Baker**. You and I have discussed that, Senator. It feels great.

ABOLISH EXEMPTION FOR STATE AND LOCAL TAXES

Senator **Moynihan**. I had one question about the proposal in the blue book, not to get you to say yes, no or even maybe, but to just ask if you could talk a little bit about an aspect of the proposal which does trouble a great many Governors, mayors, local government officials and school boards.

That is the proposal to abolish the exemption for State and local taxes. A big chunk of your piece, about one-third of the money you gain in order to reduce rates, comes from that.

It just could not but have the effect of raising the effective rate of taxation on schools, school taxes that are now paid with that lesser dollar that comes in consequence with their being deducted, will now be paid in full, and there will be, in effect, an increase.

There will be a lot of other changes that you can anticipate. The property values, the demand curve for housing will shift downward and to the right, and then the price of houses will drop.

Have you thought about that in terms of, well, two things? One is do you have some general data or what you think will be the consequences, and two, has it ever occurred to you as good decentralizers, and I think that you are that, that the more you make it difficult for local governments to support their own activities, the more they are going to demand that the Federal Government support them?

FAMILIES BETTER OFF FROM OVERALL TAXES PAID

Secretary **Baker**. Senator, we are not trying to make it more difficult for local governments. We have some data which I will be glad to get for you that indicates that a median family of four in New York State is better off from the standpoint of overall taxes paid if they were under the Treasury proposal with the elimination of the deduction for State and local income tax in a State like New York with high State and local taxes. We will get that for you.

[The following was subsequently supplied for the record:]

JOINT RETURN OF FAMILY OF FOUR EARNING THE NEW YORK STATE MEDIAN INCOME

This example illustrates a joint return of a one-earner couple with two dependents living in New York State. The family earns the estimated median income for a family of four living in New York in 1986 of $35,160; total wages equal $32,660, interest income and dividends received equal $1,980 and $520, respectively (which are the average amounts of interest and dividends received by families with adjusted gross income between $30,000 and $40,000).

Under current law, the family excludes $200 of dividends received but includes the full nominal amount of interest income. Under the Treasury proposal, the family includes all dividends received in taxable income but excludes 40 percent of interest income due to the interest indexing exclusion, when fully phased in. The family makes Individual Retirement Account (IRA) contributions of $2,150. The family deducts the estimated average amount of current itemized deductions for a joint return from New York with $35,160 of adjusted gross income ($8,130, including $3,730 of state and local taxes and $630 of charitable deductions).

Under current law for 1986, the family would have $4,420 of allowable itemized deductions in excess of the zero bracket amount and $4,360 of personal exemptions. Their taxable income would be $24,030 and tax liability would be $3,162, with a marginal tax rate of 22 percent.

Under the Treasury proposal, the family would have $3,640 of total itemized deductions, so would choose the higher zero bracket amount of $3,800. The IRA contribution is assumed to remain the same. Personal exemptions would increase to $8,000.

Thus, although the family no longer itemized deductions, its taxable income would be $24,218 and its tax liability would be $3,063 with a marginal tax rate of 15 percent. Tax liability for this hypothetical family would be $99 less than under current law.

TAX UNDER 1986 CURRENT LAW AND UNDER THE TREASURY PROPOSALS FOR A FAMILY OF FOUR LIVING IN NEW YORK STATE EARNING THE MEDIAN FAMILY INCOME

	Current law	Treasury proposals
Total money income	$35,160	$35,160
Wages and salary [1]	32,660	32,660
Interest	1,980	1,980
Dividends	520	520
Less dividend exclusion	−200	−0
Less interest indexing exclusion [2]		−792
Less contribution to IRA [3]	−2,150	−2,150
Adjusted gross income	32,810	32,218
Total itemized deductions [4]	−8,130	−3,640
Less zero bracket amount	3,710	3,800
Allowable itemized deductions	−4,420	−0
Personal exemptions	−4,360	−8,000
Taxable income	24,030	24,218
Tax liability	3,162	3,063
Marginal tax rate (percent)	22	15

[1] Assumes family has only 1-wage earner and earns only taxable income.

[2] Assumes a fully phased in interest indexing exclusion of 40 percent.

[3] Approximately 27 percent of families with AGI between $30,000 and $40,000 nationally made IRA contributions in 1982.

[4] Based on an interpolation of 1982 average itemized deductions for joint returns with $30,000–$50,000 of adjusted gross income filed by New York State families reporting itemized deductions.

Source: Office of the Secretary of the Treasury; Office of Tax Analysis, March 1, 1985.

Secretary **BAKER**. It seems to me that the taxing jurisdictions would not object to this. If you reduce all rates down so the maximum rate is 35 percent and maintain revenue neutrality, you are going to have to have an increase in the adjusted gross income of taxpayers generally.

It is my understanding that 32 States compute their State income taxes on the basis of Federal adjusted gross income or Federal taxable income. Therefore, their take will be larger. They will be able to reduce their tax rates and get the same income.

Now, that is what our data show. Beyond that, I have no further response. Quite frankly, sir, New York State is the only State that we are hearing significant complaints from with respect to that particular provision.

Senator **MOYNIHAN**. Do not tempt me, Mr. Secretary.

There is one area I think has got to be seriously thought out which would be the impact of this on the resources of school boards. We have something very special in this country. We almost have two sets of governments. One is for general government, and the other is for education.

In just about every State in this country you have school districts with taxing powers, to borrow, lend, build, run, and I am not sure they have been taken into account here that we can continue the conversation, and once again, welcome.

ic assumptions with respect to real growth and interest rates used in the administration's budget calculations.

Line 5 of this table shows that Government spending on all nondefense activities except social security and medicare took 9.3 percent of GNP in 1980. In the current fiscal year, that share is down to 7.5 percent of GNP, a decline of one-sixth.

Between 1980 and the current fiscal years, real spending on all nondefense activities except social security and medicare will have fallen by 12.6 percent. That is absolutely unprecedented. In the 5 preceding 4-year periods between 1960 and 1980, this real spending rose by amounts ranging from 11 percent to 38 percent.

If the current services level of these activities is maintained, this domestic spending share will be down to 6.7 percent of GNP by the 1986 fiscal year and thus back to the same GNP share as the late 1960's. This decline as a percent of GNP means that total spending on these activities will be $250 billion less in the 3 fiscal years from 1984 through 1986 than it would have been if 1980's GNP share had continued.

SUSTAINED DEFICITS ARE SERIOUS PROBLEM TO ECONOMY

Despite the progress that has been achieved in setting the domestic outlay share of GNP on a declining path, more needs to be done. The administration's economic projections imply that the budget deficit will remain roughly $200 billion a year for the rest of the decade unless there is legislative action to reduce spending or raise revenue. These deficits would occur even with the administration's economic forecast of strong growth and declining interest rates. If real growth is slower, and interest rates do not decline, the deficits could be substantially greater.

Sustained deficits of $200 billion a year—more than 4 percent of GNP—would be a serious problem for the American economy. It would reduce capital accumulation and long-term growth. It would cause the annual burden of financing the national debt to rise by as much as $100 billion a year by the end of the decade. And it would cause a lopsided recovery that is likely to be more fragile, slower-paced, and more inflationary than a balanced recovery.

In last year's budget, the administration proposed an appropriate deficit reduction program that would have begun with small reductions in the deficits of 1984 and 1985 but that would have reduced the 1986 deficit by 45 percent and cut the 1988 deficit to only 1.6 percent of GNP. The administration's program called for a balance of spending cuts, entitlement reforms and a contingent tax increase. As you know, the year ended without any legislative progress.

DEFICITS BEING DEALT WITH BY TWO-STAGE APPROACH

It is widely agreed that in this election year, it is not going to be possible to enact legislation that can eliminate the budget deficit by the end of the decade. The administration is therefore taking a two-stage approach to dealing with the prospective budget deficits.

The President has called upon the leaders of the Congress to establish a bipartisan group to work with the administration to develop a downpayment package that will reduce the deficit by about $100 billion over the next 3 fiscal years.

Everything is negotiable. It should be possible to achieve such reductions by a combination of specific spending reductions and revenue increases that can command a widespread consensus.

I hope very much that these negotiations will be successful and that Congress will enact such a deficit reduction package during the next few months. Such legislation would give renewed confidence to the financial markets—and indeed, to the American people as a whole—that the projected deficits can be controlled and eventually eliminated. The result should be a stronger economy in 1984 and 1985.

It is really important that last year's stalemate not be repeated this year. The budget negotiations should proceed quickly and legislation should be enacted as soon as possible.

A downpayment package is, of course, just a first step. When Congress returns in 1985, it will be necessary to take additional measures that will have a larger impact on the deficits in fiscal year 1986 and beyond.

The future success of the American economy depends on the appropriateness of our Nation's fiscal and monetary policies. The administration's projection of sound growth with declining inflation and interest rates is based on the premise that appropriate monetary and fiscal policies are pursued during the coming years.

DECLINE EXPECTED IN GROWTH OF MONETARY AGGREGATES

More specifically, the growth of the monetary aggregates is expected to decline over the next several years except for adjustments to compensate for institutional changes or other persistent shifts of velocity. For fiscal policy, we assume that Congress will enact changes in spending and tax rules that reduce the deficit substantially over the next several years and put the budget on its way to balance.

With these assumptions about monetary and fiscal policy, we project real growth at an average rate of 4 percent from the final quarter of 1983 to the final quarter of 1989. We project that the inflation rate, as measured by changes in the GNP deflator, will rise temporarily to 5 percent in 1984 and will then fall gradually to 3.5 percent by 1989. With declining inflation, appropriate monetary policy, and shrinking budget deficits, interest rates should decline in the years ahead.

The forecasts assume that the Treasury bill rate will decline from the current level of about 9 percent to 5 percent in 1989.

A more complete discussion of our forecast and its underlying assumptions is presented on page 8[1] to the end of this testimony, but I will not read that to you today.

Of course, inappropriate monetary policies or a failure to agree on a deficit reduction downpayment package now and a more substantial program of deficit reductions in 1985 would leave the economy with very much less satisfactory economic prospects in the years ahead. An excessively tight monetary policy could cause an economic downturn, while an excessively easy monetary policy could cause a rise in inflation.

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[1] See p. 255.

Failure to reduce the deficits adequately would cause an unbalanced recovery that would likely make expansion slower, more fragile, and accompanied by a higher rate of inflation.

In conclusion, I want to emphasize the importance of the bipartisan negotiations on the budget deficit. If these negotiations are successful, we will have achieved a down payment not only on deficit reduction, but also a downpayment on securing a healthy and prosperous economic future.

Thank you, Mr. Chairman.

[The prepared statement of Dr. Feldstein follows:]

The Budget Deficit and Government Spending

by

Martin Feldstein

Thank you, Mr. Chairman. I am very pleased to appear again before this distinguished Committee.

The primary economic problem that faces this Committee and the Congress is to reduce the budget deficit during the next several years in a way that does not harm the economy in either the short term or the more distant future. Before I discuss the Administration's proposals for dealing with the deficit, I want to comment on the recent experience in controlling Federal government spending.

Government Spending

Between 1960 and 1980, government outlays on nondefense programs doubled, rising from 7.5 percent of GNP in 1960 to 15.1 percent of GNP in 1980. The rise in Social Security benefits and the introduction of Medicare accounted for slightly less than half of this 7.6 percentage point increase. The remaining 4.2 percentage point rise reflects increases in a very wide range of programs from means tested entitlements to the operation of individual government agencies.

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*Chairman, Council of Economic Advisers. This testimony was presented to the Senate Budget Committee on February 3, 1984.

During the past three years, there has been a remarkable revolution in government spending. Social Security benefits are now at least temporarily taking a decreasing share of GNP. All domestic spending other than Social Security and Medicare has already declined significantly as a share of GNP and is expected to decline further in the coming years.

Table 1 presents Federal government outlays and receipts as percentages of GNP in fiscal years 1960, 1970, and 1980 through 1989. The values for 1984 through 1989 reflect estimated current services levels for all domestic programs, the Administration's FY 1984 budget proposal for defense, and the economic assumptions with respect to real growth and interest rates used in the Administration's current budget calculations.

Line 5 of this table shows that government spending on all nondefense activities except Social Security and Medicare took 9.3 percent of GNP in 1980. In the current fiscal year, that share is down to 7.5 percent of GNP, a decline of one-sixth.

Between 1980 and the current fiscal years, real spending on all nondefense activities except Social Security and Medicare will have fallen by 12.6 percent (see line 5 of Table 2). This is absolutely unprecedented; in the five preceding four-year periods between 1960 and 1980, this real spending rose by amounts ranging from 11 percent to 38 percent.

If the current services level of these activities is maintained, this domestic spending share will be down to 6.7

Table 1

Budget Receipts and Outlays
Percents of GNP
(Fiscal Years)

	Actual						Current Services						Policy
	1960	1970	1980	1981	1982	1983	1984	1985	1986	1987	1988	1989	1989
1. Total Outlays	18.5	20.2	22.4	22.8	23.8	24.7	24.0	24.3	24.1	23.8	23.4	23.0	22.1
2. National Defense	9.7	8.4	5.2	5.5	6.1	6.5	6.7	7.3	7.6	7.7	7.7	7.8	7.6
3. Net Interest	1.4	1.5	2.0	2.4	2.8	2.8	3.0	3.0	3.0	3.0	2.8	2.6	2.4
4. Other	7.5	10.3	15.1	15.0	15.0	15.4	14.3	14.0	13.4	13.1	12.9	12.6	12.1
5. Non-OASDHI	5.1	6.5	9.3	8.8	8.4	8.4	7.5	7.2	6.7	6.4	6.2	5.8	5.5
6. OASDHI	2.3	3.8	5.8	6.2	6.6	6.9	6.8	6.7	6.7	6.7	6.7	6.7	6.6
7. Social Security	2.3	3.1	4.6	4.8	5.1	5.3	5.0	4.9	4.8	4.8	4.7	4.7	4.6
8. Medicare	0.0	0.6	1.2	1.4	1.5	1.6	1.7	1.8	1.9	1.9	2.0	2.1	1.9
9. Total Receipts	18.6	19.9	20.1	20.8	20.2	18.6	18.7	19.0	19.0	19.0	19.3	19.4	19.8
10. OASDHI	2.1	3.9	5.3	5.6	5.8	5.7	5.9	6.1	6.1	6.2	6.5	6.6	6.7
11. Other	16.4	16.0	14.8	15.2	14.4	12.9	12.9	12.9	12.9	12.9	12.9	12.8	13.1
12. Deficit	-0.1	0.3	2.3	2.0	3.6	6.1	5.3	5.3	5.1	4.8	4.1	3.6	2.3
13. GNP	97.9	968.8	2575.8	2882.0	3057.3	3228.0	3558.7	3890.1	4231.3	4589.3	4963.0	5348.8	5348.8

CEA

percent of GNP by FY 1986 and thus back to the same GNP share as the late 1960's. This decline as a percent of CNP means that total spending on these activities will be $250 billion less in the three fiscal years from 1984 through 1986 than it would have been if 1980's 9.3 percent GNP share had continued.

Budget Deficits

Despite the progress that has been achieved in setting the domestic outlays share of GNP on a declining path, more needs to be done. The Administration's economic projections imply that the budget deficit will remain roughly $200 billion a year for the rest of the decade unless there is legislative action to reduce spending or raise revenue. These deficits would occur even with the Administration's economic forecast of strong growth and declining interest rates. If real growth is slower and interest rates do not decline, the deficits could be substantially greater.

Sustained deficits of $200 billion a year -- more than 4 percent of GNP -- would be a serious problem for the American economy. It would reduce capital accumulation and long-term growth. It would cause the annual burden of financing the national debt to rise by as much as $100 billion a year by the end of the decade. And it would cause a lopsided recovery that is likely to be more fragile, slower paced, and more inflationary than a balanced recovery.

In last year's budget, the Administration proposed an appropriate deficit reduction program that would have begun with small reductions in the deficits of 1984 and 1985 but that would have reduced the 1986 deficit by 45 percent and cut the 1988 deficit to only 1.6 percent of GNP. The Administration's program called for a balance of spending cuts, entitlement reforms and a contingent tax increase. As you know, the year ended without any legislative progress.

It is widely agreed that, in this election year, it is not possible to enact legislation that can eliminate the budget deficit by the end of the decade. The Administration is therefore taking a two-stage approach to dealing with the prospective budget deficits.

The President has called upon the leaders of the Congress to establish a bipartisan group to work with the Administration to develop a downpayment package that will reduce the deficit by about $100 billion over the next three fiscal years. Everything is negotiable. It should be possible to achieve such reductions by a combination of specific spending reductions and revenue increases that can command a widespread consensus.

I hope very much that these negotiations will be successful and that Congress will enact such a deficit reduction package during the next few months. Such legislation would give renewed confidence to the financial markets -- and indeed to the American people as a whole -- that the projected deficits can be controlled and eventually eliminated. The result should be a stronger economy in 1984 and 1985.

It is important that last year's stalemate not be repeated this year. The budget negotiations should proceed quickly and legislation should be enacted as soon as possible.

A downpayment package is, of course, just the first step. When Congress returns in 1985, it will be necessary to take additional measures that will have a larger impact on the deficits in fiscal year 1986 and beyond.

The future success of the American economy depends on the appropriateness of our nation's fiscal and monetary policies. The Administration's projection of sound growth with declining inflation and interest rates is based on the premise that appropriate monetary and fiscal policies are pursued during the coming years. More specifically, the growth of the monetary aggregates is expected to decline over the next several years except for adjustments to compensate for institutional changes or other persistent shifts of velocity. For fiscal policy, we assume that Congress will enact changes in spending and tax rules that reduce the deficit substantially over the next several years and put the budget on its way to balance.

With these assumptions about monetary and fiscal policy, we project real growth at an average rate of 4.0 percent from the final quarter of 1983 to the final quarter of 1989. We project that the inflation rate, as measured by changes in the GNP deflator, will rise temporarily to 5.0 percent in 1984 and will then fall gradually to 3.5 percent by 1989. With declining inflation, appropriate monetary policy, and shrinking budget deficits, interest rates should decline in the years ahead. The forecasts assume that the Treasury bill rate will decline from the current level of about 9 percent to 5.0 percent in 1989. A more complete discussion of the Administration's forecast is presented in the attachment to this testimony.

Of course, inappropriate monetary policies or a failure to agree on a deficit reduction downpayment package now and a more substantial program of deficit reductions in 1985 would leave the economy with very much less satisfactory economic prospects for the years ahead. An excessively tight monetary policy could cause an economic downturn while an excessively easy monetary policy would cause a rise in inflation. Failure to reduce the deficits adequately would cause an unbalanced recovery that would likely make expansion slower, more fragile, and accompanied by a high rate of inflation.

In conclusion, I want to emphasize the importance of the bipartisan negotiations on the budget deficit. If these negotiations are successful, we will have achieved a downpayment not only on deficit reduction but also a downpayment on securing a healthy and prosperous economic future.

The Economic Outlook for 1984-89

The Administration's new economic projections for 1984 through 1989 are shown in Tables 2 and 3. Our current economic assumptions repeat last year's projections that the economy will experience strong growth with declining inflation over the next six years.

Real GNP is projected to grow 4.5 percent between the fourth quarter of 1983 and the fourth quarter of 1984. The inflation rate, as measured by the GNP deflator, is projected to be 5.0 percent over the same period. This coincides with the Administration's projections in the midsession review prepared in June of last year, and with last February's inflation projection. It represents an increase of one-half percent from the growth rate projected in the outlook that I presented here last February.

For 1985 through 1988, real GNP is projected to grow at 4.0 percent annually, the same growth rate that we projected for these four years in our outlook of a year ago. We assume that capacity is approached at the end of this period and that real GNP in 1989 is then projected to grow at 3.75 percent.

These growth rates are associated with a substantially improved outlook for unemployment in recent months, the average unemployment rate for 1984 is now projected to be 7.8 percent. The current projection of the unemployment rate indicates that unemployment will decline gradually to a rate of 5.7 percent in 1989. This reflects the completion of the

Table 2

Six Year Economic Assumptions: Growth Rates

	Real GNP Growth Rate	
	4th Quarter to 4th Quarter	Year to Year
1984	4.5	5.3
1985	4.0	4.1
1986	4.0	4.0
1987	4.0	4.0
1988	4.0	4.0
1989	3.7	3.9

	Inflation GNP Deflator	
	4th Quarter to 4th Quarter	Year to Year
1984	5.0	4.5
1985	4.7	4.8
1986	4.4	4.5
1987	4.1	4.2
1988	3.8	3.9
1989	3.5	3.6

	Nominal GNP Growth Rate	
	4th Quarter to 4th Quarter	Year to Year
1984	9.7	10.0
1985	8.9	9.1
1986	8.6	8.7
1987	8.3	8.4
1988	8.0	8.1
1989	7.4	7.6

Table 3

Six Year Economic Assumptions: Levels

	Real GNP Growth Rate (1972 dollars)		
	Calendar Year	Fourth Quarter	Fiscal Year
1984	1616.0	1641.3	1598.3
1985	1682.2	1707.0	1665.7
1986	1749.5	1775.3	1732.4
1987	1819.5	1846.3	1801.7
1988	1892.3	1920.2	1873.8
1989	1965.7	1992.3	1947.7

	GNP Deflator (1972 = 100)		
	Calendar Year	Fourth Quarter	Fiscal Year
1984	225.4	229.5	222.7
1985	236.2	240.3	233.5
1986	246.9	250.9	244.2
1987	257.3	261.1	254.7
1988	267.4	271.1	264.9
1989	277.0	280.6	274.6

	Nominal GNP Growth Rate		
	Calendar Year	Fourth Quarter	Fiscal Year
1984	3642.4	3766.8	3558.9
1985	3973.8	4101.6	3890.1
1986	4319.2	4453.5	4231.3
1987	4681.2	4821.4	4589.3
1988	5059.0	5205.1	4963.0
1989	5444.9	5589.4	5348.8

	Total Unemployment Rate		91-Day Treasury Bill	
	Annual Average	Final Quarter	Annual Average	Final Quarter
1984	7.8	7.7	8.5	8.3
1985	7.6	7.5	7.7	7.5
1986	7.3	7.2	7.1	6.9
1987	6.8	6.5	6.2	6.0
1988	6.1	5.8	5.5	5.3
1989	5.7	5.7	5.0	5.0

cyclical recovery and the effects of the Administration's enacted and proposed employment policies in reducing the structural unemployment rate.

Another unexpectedly favorable development in recent months has been the rapid decline in inflation. Inflation, as measured by the GNP deflator, has been less in 1983 than the 4.6 percent anticipated in the midsession review. Although we continue to project a 5.0 percent rise in the 1984 GNP deflator, the inflation rate is then projected to decline gradually but steadily to 3.5 percent by 1989.

The combination of falling inflation and declining budget deficits imply that nominal and real interest rates will also decline. Our projections assume that the interest rate on three-month Treasury bills declines from the current level of nearly 9.0 percent to 5.0 percent in 1989.

The Administration's projections for 1984 are very similar to the thinking of most private economists. The consensus of the 45 economists in the January 1984 survey indicated a real GNP growth rate of 4.4 percent from the fourth quarter of 1983 to the fourth quarter of 1984, almost identical to the Administration's projected 4.5 percent rate. Similarly, the Blue Chip consensus indicates a GNP deflator increase of 5.2 percent in 1984, also almost identical to the Administration's 5.0 percent rate of inflation.

Secretary **Baker**. I think the current course of monetary policy is quite adequate, Senator, and, yes, I am pleased.

CHANGES IN TREASURY DEPARTMENT BEING STUDIED

Senator **Sasser**. Would you anticipate sending up—I have heard some talk, at least there was talk on one or two occasions in times past about doing away with the independence of the Federal Reserve Board and putting it over in the Treasury Department. We would not be seeing a bill coming over here with the administration's imprint on it, in your judgment, in the near future asking the Congress to put the Federal Reserve activities with regard to monetary policy under the Department of Treasury, would we?

Secretary **Baker**. No, Senator. However, I must confess to you that there is a study undertaken in the Treasury Department at a lower level which considers a number of changes in the relationship between the executive branch and the Fed. These include making the Secretary of the Treasury a member of the Open Market Committee, putting the Federal Reserve budget back in the hands of the Congress, and making the chairman's term coterminous with that of the President.

None of those have been signed off on by me, let alone the President or by the administration. A study exists. I have not had a chance, quite frankly, in the two weeks I have been there to sit down and review it.

I did testify when I was confirmed that I do support the idea of making the chairman's term coterminous with that of the President, but I think the chairman himself supports that so there is no difference of opinion there.

I happen to believe that there has to be the closest coordination possible between the Treasury and the Federal Reserve since we are, I suppose, one of the few nations who have this kind of a relationship between the central bank and the Treasury.

And I have also said that I think that coordination should be exercised in private and every effort should be made to handle the relationship in private. It would only be if we were unable to see eye to eye or to reach an accommodation in private, if we had made every effort to do it in private, that I would feel free to answer questions up here or anywhere else with respect to my views on monetary policy as exercised by the Fed.

In other words, I do not think that ought to be characterized, sir, if I may say so, as Fed bashing—not if we have tried to work things out and there is an honest difference of opinion.

I think sometimes we tend to characterize those honest differences of opinion as Fed bashing. The Fed feels quite comfortable criticizing the administration's fiscal policy from time to time when we are unable to reach private accommodation. All I am suggesting is that ought to be a two-way street.

Senator **Sasser**. Well, I am not condemning anybody, Mr. Secretary, for Fed bashing. So do not misunderstand.

Secretary **Baker**. I understand. I just want to get into the record where I stood on that.

Senator **Sasser**. Let me inquire further about your Treasury Department study with regard to the Fed. How long has that study been ongoing and what precipitated it?

Secretary **Baker**. I think it has been ongoing for the better part of 6 to 9 months. I think 6 to 9 months is an accurate answer. I think dissatisfaction with what the Treasury viewed as an overly restrictive monetary policy by the Fed precipitated it.

CONFLICT BETWEEN MONETARY AND FISCAL POLICY

Senator **Sasser**. I see. In our first week of testimony Paul Volcker spoke of the pressures of the large Federal deficits and with regard to long-term price stability, the pressure they create with regard to long-term price stability.

And just yesterday, the Secretary of State, Mr. Shultz, who we sometimes forget is a respected economist in his own right, expressed his view that long-term interest rates remain high because of fear that the Federal deficits will eventually force the Federal Reserve to monetize a large portion of that debt.

Now, this week another symptom of this long running conflict that we have had in my judgment since 1981 between monetary policy on the one hand with the Federal Reserve and the fiscal policy on the other hand as pursued by the administration became apparent.

As the dollar continued to rise against all other major currencies, I think you, as Secretary of the Treasury, intervened in the currency markets to slow the rise of the dollar.

Now, as I understand this procedure, this intervention in the foreign exchange market creates more dollars. So in the international currency market, massive Federal borrowing to cover our deficit has pushed the dollar to such a level that we, as a government, feel compelled to intervene in the international market to stabilize the price of the dollar.

Now, isn't this telling us that the conflict between monetary and fiscal policy is getting closer and closer to a showdown, that the deficits now are forcing us to choose between continued damage to the U. S. trade sector as the dollar floats up and gets even higher or to choose between unleashing inflationary forces in our own economy to deal with the problem if we are forced to monetize a large portion of the debt as Secretary Shultz says many economists or long-term lenders fear that we will.

Secretary **Baker**. Let me give my best answer to that. You have a number of questions in there. In the first place, I do not think that there is necessarily a conflict between fiscal and monetary policy.

We are, as I just said, satisfied with the monetary policy that the Federal Reserve is now pursuing. I do not think the Federal Reserve is dissatisfied with the budget deficit reduction target that we have ascertained. After all, we are asking for $50 billion which is what the chairman himself said is the appropriate figure.

So I do not see a conflict. We continue to have sustained economic growth in this country as I indicated in my statement, and we have it without inflation. We are enjoying it without inflation even without there being an overly restrictive monetary policy in force.

REASONS FOR LOW INFLATION

Senator Sasser. Would we have to agree, though, Mr. Secretary, that others in this economy are paying for this low inflation. Farmers are paying for it, for example, and those who are losing their jobs to the imports coming into this country are paying for it also. So it is not without considerable cost.

Secretary Baker. Well, I do not think the strong dollar is the only reason that we do not have inflation. I think there are other major reasons. As far as the strength of the dollar is concerned, you are right in that part of your question that suggested that we had intervened in the currency exchange markets pursuant to understandings we had with some of our trading partners.

But I would disagree with the conclusion of your question, if I understand it, that the strength of the dollar results solely from Federal borrowings to cover our massive Federal deficit.

I think the dollar is strong, quite frankly, because our economy is in very good shape and because we are a safe haven. People want to invest here and we have political stability and there are a whole number of reasons, only one of which is the reason that you suggest.

That is another reason why we are interested in doing something about the fiscal deficit, and I think that is one reason that real interest rates, as opposed to nominal interest rates, do remain high.

Senator Sasser. Well, real interest rates are running now at about what, 6–7 percent?

Secretary Baker. Six. Real interest rates would be around 6. You have 10½ prime and you got inflation at 4 so real interest is about 6.

Senator Sasser. What would happen, do you think to the strength of the American dollar, Mr. Secretary, if nominal interest rates in this country fell to 6 or 7 percent.

Secretary Baker. What would happen to the dollar?

Senator Sasser. The dollar on the international market. Would you see an exodus of dollars out of this country?

Secretary Baker. I do not know. You know, our trading partners tell us that our high deficit is the cause of the strong dollar, and therefore, we ought to do something about our deficit. I am not an economist, but I have never heard of an economy that got its fiscal affairs in order and had its currency weaken.

If we do something about our deficit, it is not unlikely that our dollar could get even stronger. I do think that the high interest rate that we have now is one of the things that serves to prop the dollar up. I am not disagreeing with you on that.

All I am saying is that if we take the bitter medicine of fiscal discipline, we are not at all sure that it is going to weaken the dollar.

Chairman Domenici. The Senator's time has expired.

Senator Sasser. Mr. Chairman, thank you for calling my attention to the fact that my time has expired. I wish you would do that to all of our colleagues on this committee.

Chairman Domenici. I waited a long time before I told you.

Senator Gorton.

RELATIONSHIP BETWEEN REDUCING DEFICITS AND VALUE OF DOLLAR

Senator **GORTON**. As a matter of fact, Senator Sasser, I am just going to pursue the same line of questioning. I want to say once again, Mr. Secretary, Chairman Volcker has apparently restated this morning his comments of a couple of weeks ago that although he has strongly favored reducing budget deficits and is greatly concerned with the imbalance of trade he questions whether or not there is a direct relationship between our reducing budget deficits and the value of the dollar overseas.

I gather that your view is that even if we were to reduce the deficit for 1986 by $50 to $55 billion under the baseline and even though most or all of that reduction resulted from spending cuts the value of the dollar may not decline relative to against foreign currencies. In fact, could such measures in the short run possibly increase the value of the dollar?

Secretary **BAKER**. It is possible, Senator. What I meant to convey is we do not really know. I agree with Chairman Volcker on that.

INTERVENTION IN FOREIGN EXCHANGE MARKETS

Senator **GORTON**. Prime Minister Thatcher has been with us here today, Mr. Secretary, and I think again in answer to one of Senator Sasser's questions you made a glancing comment with respect to intervention in foreign exchange markets.

Your predecessor last month said that the United States would intervene if it would be helpful, and I gather from what he has told us and perhaps what you have told us, there have been minor intervention activities in an effort to slow the rise of the dollar.

Would you explain what current American policy is, and what policy you propose to follow with respect to intervention in foreign exchange markets?

Secretary **BAKER**. The current policy, Senator, is to intervene only when markets are disorderly. We did indicate at the G-5 meeting on January 17 that we would take a step or two further, but I really do not want to get into that here. I would be delighted to submit something to you in executive session. I really do not want to get into the details of whether it has been minimal or whether it has been extensive. I do not think we ought to give currency speculators the benefit of that knowledge. I would be delighted to share it with you.

Senator **GORTON**. OK. Thank you very much. I will go on to your interpretation of what has gone on overseas. Do you know how much money foreign central banks have lost as a result of recent interventions in foreign exchange markets? Have the central banks of Germany and England been selling dollars and has the dollar strengthened nevertheless costing those central banks considerable amounts of money?

Secretary **BAKER**. May I give you this in executive session, Senator?

Senator **GORTON**. Yes, if that is the way you wish to do it.

Secretary **BAKER**. Well, I would prefer to, Mr. Chairman, if you do not mind.

Chairman **DOMENICI**. Has that not been revealed yet?

Secretary **BAKER**. No, sir.

Chairman Domenici. Why do we not accommodate the Secretary in that regard then?

Secretary Baker. I would be delighted to do that.

Senator Gorton. Thank you, Mr. Chairman.

Chairman Domenici. Senator Sasser, did you have some additional questions. I did not mean to cut you off any faster than I did anybody else.

Senator Sasser. No further questions. Thank you, Mr. Chairman.

Chairman Domenici. Senator Kasten.

MONEY SUPPLY GROWTH

Senator Kasten. Mr. Chairman, thank you.

I am not sure exactly what Slade was asking about because I did not have a chance to hear him. I am deeply concerned about the policy at the Fed. The Fed affects everything from the farm problems that we are currently dealing with on almost a crisis basis, to the problems with the balance of trade, to domestic interest rates. They simply cannot continue to have the economy growing at one pace and the growth of money at another. Nor can they continue to change the pace from month to month.

We have had an erratic kind supply of money. As the new Secretary of Treasury, do you think the money supply has been growing too slowly over the past 2½ years, about right or too fast?

Secretary Baker. Well, I think for the most part, Senator, I would agree with the growth in the money supply. However, there are at least two instances where I would disagree, and one was in 1981 when I think the Federal Reserve was perhaps overly restrictive. Maybe with 20/20 hindsight they might agree with this, and as a result, we had a far deeper recession than we might otherwise have had.

I would tend, likewise, to disagree with respect to the setting of the ranges initially in 1984. I think there was every indication that growth would exceed the ranges that were set. In fact, when it did exceed those ranges, and was cut, we had a rather disappointing third quarter as a result.

I have just answered Senator Sasser's question about whether I agreed with the current course of monetary policy. I do, and I think the current course is quite adequate.

FED GROWTH TARGETS

Senator Kasten. Yesterday, Mr. Niskinnin of the CEA said that they believe that growth in the money supply will be within the targets for 1985. I have not seen the targets for 1985. What is the target level for 1985?

Secretary Baker. The target level for M-1 is the only one I can give you, because I do not have committed to memory what their targets are on M-2 and M-3. The target range on M-1, as I understand it, for 1985 is 4 to 7 percent which, of course, is consistent with our estimate of growth.

Senator Kasten. It will be if the Fed stays at the top of the range. As your examples show, the Fed tends to stay near the bottom of the range. They never even have gone up over the middle as far as I know.

Are you, as Secretary of the Treasury, going to be riding herd on them to see, No. 1, that they stay within those ranges, and No. 2, that you do what you can publicly and privately to see that we have the kind of growth in money supply that you are supporting here?

Secretary **Baker**. Well, certainly I am going to do what I can privately, Senator. I just answered a question with respect to that a minute ago. My view of the relationship is basically that there has got to be close coordination and that it is best done privately. It is more effectively done if we are talking to each other and not about each other. Where there is disagreement, to the extent possible, that disagreement should be discussed privately before there is any expression of disagreement publicly.

But, yes, we are very interested in seeing the Fed perform as closely as they can within their ranges. We accept the fact, of course, that sometimes the tools that they have are rather blunt instruments but we will be very interested in those ranges and how the Fed is performing against them.

SECRETARY OF THE TREASURY CHANGES BEING STUDIED

Senator **Kasten**. Some of us want to help you a little bit, and there are two different approaches that have been taken. The first is to have the Secretary of the Treasury serve as a member of the FOMC. Another is to speed up the timeliness of the publication of the minutes of the policy meetings.

Do you believe that the Secretary of the Treasury should be a member of the Federal Reserve Board?

Secretary **Baker**. We have a low-level study, as I just testified, Senator, at Treasury which considers a number of options. I have been there 2 weeks, and I have not had a chance to get involved with it yet as I expect to later.

One of the issues is whether the Secretary of the Treasury ought to be a member of the Open Market Committee. One is whether or not the minutes ought to be published. Another is whether the term of the chairman ought to be coterminous with that of the President.

That final one I support and the Fed, as I undertand it, supports it. The bottom line is I have not had a chance to look at that study. I plan to do so.

BASIS OF 4 TO 7 PERCENT TARGET

Senator **Kasten**. Just one last question. You talked about the 4 to 7 target. Is that based on a 4-percent rate of growth?

Secretary **Baker**. I do not know.

Senator **Kasten**. One of the problems we have had is that their estimates on growth have always been wrong. They have been too low. The result is that the monetary targets have been too low. It is a problem that kind of compounds itself.

Secretary **Baker**. It is a growth rate of 3½ to 4 percent—roughly the same as projected by the administration.

Senator **Kasten**. Some of us around this table are hoping for a little bit better than 3½ to 4 percent, Mr. Secretary. But that means that it is even more important that those numbers are up there bumping against the 7 rather than down there between 3½ and 4 percent, which has been their habit in the past.

Secretary **Baker**. Right.

Senator **Kasten**. Thank you, Mr. Chairman.

Chairman **Domenici**. The record should reflect that he nodded yes.

Senator **Kasten**. An enthusiastic nod, too, I think, Mr. Chairman.

Chairman **Domenici**. Senator Chiles.

ADMINISTRATION SUPPORTS CORPORATE MERGER ACTIVITIES

Senator **Chiles**. Mr. Secretary, in the economic report of the President, the administration comes out strongly in support of all the corporate merger activity we have been seeing in the last few years.

Not only has the value of this merger activity, about $345 billion during the President's first term, been far beyond any previous levels, but what really stands out is the fact that the bulk of this activity is due to a relatively few megamergers.

It seems to me the administration's actions have been largely responsible for a lot of this takeover activity. The Justice Department contends that the Clayton Act does not exactly exist, and overly generous corporate tax preferences provide tremendous incentives for tax motivated mergers which, in the words of the President's latest economic report, make little economic sense in the absence of their tax benefits.

Just as these megamergers have been absorbing our Nation's scarce capital allowing the big to get bigger, it looks like the budget which has been set up by the administration would put the little guy at a greater disadvantage by limiting credit assistance to small business.

The Small Business Administration is being changed. The Farmers Home Administration is being changed to assess fees. So, in effect, the administration's policies seem to favor those large corporations over other sectors of the economy.

I wonder as our chief tax and financial officer whether you agree that this is an imbalance we need to correct so the small firms and new firms that are real engines of innovation and new technology will not be denied the capital they desperately need.

Secretary **Baker**. I would agree with that last statement, Senator. I cannot speak, of course, to Department of Justice antitrust enforcement policies. I can speak to tax preferences that have been granted to large corporations which make possible the megamerger behavior that you are speaking of. If we are able to reform the tax code generally, that is another area that hopefully would be taken care of.

I do happen to believe that with respect to corporate takeovers generally, that is not a proper subject for Federal legislation. I think we best leave that to the courts.

My own view is that that is an area that the Federal Government really does not need to be involved in, but we need a level playing field. I agree with you.

SMALL BUSINESSES HAVE HARD TIME GETTING CREDIT

Senator **Chiles**. What about a capital crunch like we had in 1973, 1974. We had it in the last recession of 1981, 1982. Small businesses were not able to get credit, or if they did, they got it at terribly high rates.

Yet a duPont could tie up $12, $15 billion because he wanted to pursue a merger. Of course, they got that at 1 percent over prime or at a very low interest rate. You could understand why one of the major banks would rather make a gold edged loan like that and tie up that money as opposed to putting it into small businesses. Where is the voice of the Fed, and the jawboning voice of the President or the Secretary of the Treasury in that kind of situation?

They can say, "Wait a minute. We do not think this is in the national interest of the country." Is there not a role to play there?

Secretary **Baker**. Well, yes, sir, there is, but I do not think that a proposal to do away with the Small Business Administration is going to have an adverse impact. I mean, we are talking, at least according to our data, about 22,000 out of over 14 million small businesses. I do not think that is unleveling the playing field, if I can put it that way.

Yes; we have got to encourage venture capital. We have to encourage capital formation and investment. Those are some of the things, quite frankly, that we see as possible problems in the Treasury proposal that would discourage venture capital. The proposal would discourage small businesses in the sense that it would do away with the graduated corporate income tax.

These are all things we want to take a look at.

Senator **Chiles**. That is all, Mr. Chairman.

Chairman **Domenici**. Senator Riegle.

TRADE DEFICIT RISING AND CREATING ANXIETY

Senator **Riegle**. Thank you, Mr. Chairman.

Mr. Secretary, the trade deficit is something we discussed a little bit between the two of us. The merchandise trade deficit in this year finished is in the range of $130 billion. It seems to be rising to something on the order of $150 billion, and it is creating an enormous amount of anxiety. It is not just heavy industry, the automobile industry, but it is spreading out to a whole host of sectors across the country, and I am finding that more and more business people are beginning to talk about the unfairness of the trade rules, the magnitude of the trade deficit that combined with the fiscal deficit is sort of a hemorrhage of capital out of the country, the money leaving. We are buying a lot of consumerable durables that are coming back in and, of course, a certain amount of foreign loans coming in.

But a loan from a foreigner versus our sending U.S. capital out for a durable good is a very different transaction in terms of what it means for the long pull. I am just wondering how long you think we can sustain these trade deficits at this level?

Can we just continue to digest these indefinitely and not see some kind of an impairment of our capital structure in this country, in your view, or are we going to have to reverse these trends sharply here sometime quite soon?

Secretary **Baker**. I think we are going to have to reverse the trend, Senator. I cannot put a timeframe on it.

I do think this. Part of the problem is the dollar. If we do what the President has suggested with respect to the deficit, that may help the dollar problem. The dollar problem would also be helped if we can encourage our trading partners to adopt some of the economic policies that we followed in this country and become better trading partners for us. We are trying to do that.

Frankly, they are beginning to respond because they have seen what has happened in this country.

ENFORCE LAWS AGAINST UNFAIR TRADE PRACTICES

Senator **Riegle**. What about trade barriers that they maintain against our goods?

Secretary **Baker**. That was the third point I was going to make. We need to enforce our laws against unfair trade practices aggressively—our countervailing duty laws, our dumping laws.

We need to guard against surging of imports the way the administration did last December with respect to steel. And we need, above all, to have some real jawboning with some of our trading partners with respect to the size of the deficit, and we are doing that with Japan.

Senator **Riegle**. Frankly, not very well. The President just met with Nakesone. It turns out that cars and trucks are now, by a small margin, second largest item in the balance-of-payments deficit with Japan, $15 billion, and according to reports from the White House, that subject was not raised in the 3½-hour meeting that the President and Nakesone had.

Frankly, that is a little disturbing. It is one thing to talk about the ball scores and whatever else was talked about for 3½ hours but not to get to the issue of cars and trucks seemed to me to be a pretty serious omission.

Secretary **Baker**. Well, Senator, let me suggest that the issue of cars was discussed at quite some depth in 1981, which is perhaps one reason we have a voluntary restraint agreement for them.

Let me tell you what was talked about in January. What was talked about was the yen/dollar relationship and the fact that we ought to find ways to remove the restrictions that the Japanese have on the yen and let it become more of an international capital market currency which would be very, very helpful.

Let me tell you what else was discussed. New initiatives with respect to opening up of their markets in four areas, forest products, telecommunications, medical supplies, and one other.

TRADE DEFICIT WITH JAPAN GOING TO RISE

Senator **Riegle**. Let me ask you the tough question. Did they agree to reduce the size of their trade deficit with this country? Did they make an absolute pledge that within 12 months the trade deficit would start to come down rather than go up?

Secretary **Baker**. They made a pledge to see what they could do about opening up their markets to our goods.

Senator **Riegle**. But that is different. Here is why I put the question that way. There are official estimates out of the Government showing that our trade deficit with Japan over the next 12 months is going to rise, rise substantially, by some number of billions of dollars.

It seems to me that what you need is not this elaborate minuet that goes on but rather some kind of a firm pledge from them that they are going to cap off this trade deficit and start to work it down.

What you are telling me is we get all these signals and all these signs but the numbers continue to get worse. Do you really think that is an adequate response?

Secretary BAKER. I really do believe this, Senator. I do believe they are concerned about the size of the trade deficit between us.

Senator RIEGLE. Are they going to do something about it?

Secretary BAKER. I think that because they are concerned they are going to, yes, sir.

ARE WE MEETING THE COMPETITIVE CHALLENGE?

Senator RIEGLE. I hope you are right. Let me refer to something related to that, and as you know, the President Reagan's Commission on Competitiveness just finished their work and issued their report this last week, and I think it is a pretty solid piece of work and I congratulate the work and the initiative to set the thing in motion, and this is what they say on page 1 of their report.

I do not know if you had a chance to read this. I know you have a lot of things going right at the moment, but let me just give you a paragraph or two from it.

They asked this question with respect to the world economy changing and the trade problem. They pose the question, "Are we meeting the competitive challenge?" Their answer is, "Not well enough. Our ability to compete in world markets is eroding. Growth in U.S. productivity lags far behind that of our foreign competitors. Real hourly compensation of our work force is no longer improving. U.S. leadership in world trade is declining. Even in high technology, our lead is slipping."

Then they go on on page 16. Here they list 10 high technology areas. This is a chart I had not seen before, but I think it is striking, and it is one that I think offers an enormous potential for you to give some leadership in terms of heading the Treasury Department at this time.

Going down on this list, aircraft and parts, office computing and accounting machines, engines, turbines, agricultural chemicals, on down through those kinds of items.

They point out that in 8 of these 10 areas, we are losing our percentage of world market share over the last several years. In other words, our relative position is eroding. They cite these as particularly important high tech areas which is sort of a wide area.

But they end up here with a whole series of recommendations but they say to us that time is really running out, and I do not know what sense of urgency is going to be given to this issue.

I do not see anybody yet sort of picking the ball up and running with it. One person in the cabinet who has had industrial base experience of some consequence, I think, is Mac Baldrige who did in a company that was in the international business trading sphere.

But it seems to me that your Commission here has really given you, I think, a warning signal that we are really falling behind by a whole series of yardsticks developed by people that President Reagan selected to do this assessment.

So I would hope that we would really see some aggressive leadership particularly by yourself because I think you are maybe the one person that can sort of steer into this issue.

Secretary **Baker**. Senator, let me say I do not disagree with what you said. I spent a better part of a year as the Deputy Secretary of Commerce——

Senator **Riegle**. I recall you did.

Secretary **Baker** [continuing]. And the trade deficit troubles me and it troubles me greatly, and I think we can do a better job.

INTERVENTION IN THE CURRENCY MARKETS

Senator **Riegle**. Let me just say one other thing on the intervention in the currency markets, and I got into this with Mr. Volcker this morning in the Banking Committee. I have seen this done before. I came to the Congress 19 years ago so some of these things are starting to repeat themselves.

But it has been my observation in the past that when we intervene in the international currency market it is sort of a poker game and there are a lot of speculators, and if you go in to try to do a little bit on the margin to try to move things your way, that usually does not succeed, because it is seen for what it is, and the speculators have pretty good staying power in terms of wanting to find out how much you are willing to sort of really cover your bets.

I noticed yesterday that the value of the dollar rose again sharply. I have not had a chance to see what it is doing today, and I do not know if any of your aides would have seen it. It is up again. I am not surprised to hear that, and it fits with the question I want to put to you.

That is, it seems to me that what has happened here is by trying a small amount of intervention, the folks on the other side basically are betting the dollar is going to go higher sort of are calling you on your bet

It seems to me that if you are going to have a very substantial chance of intervening successfully, you have got to be prepared to do it in a major way. I am not urging you to do that at this point. That is a very complex policy judgment.

What I am saying to you is, it seems to me if you are going to try to intervene and have an effect that lasts for more than 24 hours, you have to decide that you are at a point where you are really willing to come in with a sustained effort and stare down those on the other side that want to find out if you are just really sort of kidding in terms of your seriousness.

I am wondering where we are going to go from here. Are we going to see a sustained effort? Is it over?

Secretary **Baker**. Well, you said it yourself, Senator. You can only be successful in this game if you keep the speculators guessing. I cannot answer your question and still keep them guessing. So I will not.

Senator **Riegle**. Well, it sounds to me like what has happened the last couple of days is that they have covered your bets and the dollar is back up again. I suppose we will just have to wait and see what is done here.

Secretary **Baker**. I do not want to leave that as an answer by not answering it. I really do not want to talk about the extent to which we have intervened nor the extent to which our trading partners have intervened in conjunction with us, because I think the worse thing we can do is not leave the speculators guessing. We want to leave them guessing.

DOLLAR NOT STRONG WHEN TRADE DEFICIT STARTED TO RISE

Senator **Riegle**. Well, just one final thought and that is this. When the trade deficit started to rise, the value of the dollar was not that strong. I am not sure that if the dollar value in foreign currency relationship starts to moderate that you are going to suddenly see the trade deficit go away.

There are a lot of serious international economists who are looking at this thing and thinking that these inroads that foreign competitors are making in a whole host of areas with their products that they are digging in for the long pull.

Korea is coming on line, Singapore, the whole Asian basin countries and so forth, and I am concerned about is that I am afraid here that even if we see some improvement in the alignment of currency values that the trade deficit may stay where it is, may even go higher, partly because these countries cannot afford to give up the jobs that they have now managed to create in their society any more readily than we can.

I guess what I am saying to you is that living in the sort of the center of that storm coming from the kind of a state that I do where we have a number of product areas that are impacted I think in this area as well time is very short in terms of reversing these trend lines, and it is going to take a herculean effort.

I think it is going to be tougher to do that than it is going to be to do tax reform. I know tax reform is higher on your list but I happen to think that this problem may be cresting at a size and at a dimension that if you let it go too long you are going to find that it controls you rather than we as a nation having ability to turn the thing to our advantage.

Chairman **Domenici**. Thank you very much, Senator.

Do you have any further comments, Mr. Secretary?

Secretary **Baker**. No, sir.

Chairman **Domenici**. We stand in recess until tomorrow.

Thank you very much.

[Whereupon, at 4:30 p.m., the committee adjourned to February 21, 1985.]

VIEWS OF OUTSIDE ECONOMISTS

THURSDAY, FEBRUARY 21, 1985

U.S. Senate,
Committee on the Budget,
Washington, DC.

The committee met, pursuant to notice, at 10 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Symms, Grassley, Kasten, Gorton, Chiles, and Sasser.

Staff present: Stephen Bell, staff director; and Gail Fosler, chief economist.

For the minority: Richard N. Brandon, staff director; and John Hilley, senior economist.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman Domenici. The committee will please come to order.

It is a pleasure to welcome to our committee this morning Dr. Alan Greenspan, Prof. Rudiger Dornbusch, and Prof. William Nordhaus. Dr. Greenspan really needs no introduction to the committee. He is well known to many members and a frequent witness on economic policy matters.

As I understand, this is the first appearance for both Professor Dornbusch and Professor Nordhaus. Professor Dornbusch is currently the Ford International Professor of Economics at MIT and has held teaching positions at several other institutions including the University of Chicago, University of Rochester, and the London School of Economics. Professor Nordhaus is the John Musser Professor of Economics at Yale University and a former member of President Carter's Council of Economic Advisers. Actually, Professor Nordhaus, I note that you are the heir to Professor Samuelson's famous introductory economics text. Maybe we should apply directly to you for help in reducing the budget deficit.

What I am about to say by way of introduction may surprise you, but I am sincere. Each year we meet with a panel very much like this one. Each year they tell us about the dangers of budget deficits, the damaging effects of interest rates on capital formation, the very real threat we face to the economic expansion.

Instead, each year the economy improves; we are adding jobs at a rate of 300,000 a month; inflation is surprisingly low; and interest rates are actually about as low now as they were during the prerecovery period in early 1983. In short, gentlemen, things around this country are pretty good.

Certainly, not in every region or in every industry. But, the fact is that generally people feel pretty optimistic. It shows up in the surveys of people's confidence. I have just returned from a week at home, and the people of New Mexico are optimistic.

ONE COMPELLING PROBLEM IS THE BUDGET DEFICITS

I happen to believe that this optimism is well founded, but I fear it is not enduring. I believe that the one compelling problem standing in our way is the Federal budget deficits that CBO projects to be almost $300 billion by the end of this decade. We could be looking at a radically changed economic picture, if not this year, certainly before the 1986 elections if we don't act to reduce these deficits dramatically.

But I tell you, it is not so easy to work on this deficit when people feel so good. There is an artificial sense of calm, a lack of urgency which makes our job of taking tough actions to reduce deficits very difficult.

I hope that you will discuss your views on the short-term outlook for us this morning and how long these good times can continue if we don't act on the deficit. I hope you will give us some honest benchmarks. Projecting crisis that don't occur just weaken the commitment to act.

I also hope that you will tell us what you think will happen to the economy, in terms of growth and interest rates, if we do act on the deficits.

This is not a year like any other year. This is a unique opportunity. If we don't act to cut the deficit this year, I think we will be lucky to hold the line over the next 2 years. Indeed, if we do not act this year, we will require a crisis at great economic and political cost to get action.

With that, unless another Senator wants to be heard, I welcome you, and let us start with Dr. Greenspan, please.

STATEMENT OF DR. ALAN GREENSPAN, TOWNSEND-GREENSPAN & CO.

Dr. **Greenspan**. Thank you, Mr. Chairman.

I would like to excerpt from my formal remarks, and I would appreciate if the full text could be inserted in the record.

Chairman **Domenici**. Without objection, it will be made a part of the record.[1]

Dr. **Greenspan**. The reason why the 1984 pause of economic activity did not degenerate into another recession is that inventories remained exceptionally low by historic standards, and capital investment was expanding. The period was scarcely describable in terms of an unsustainable boom, nor were there the clear credit stringencies which typically predate the beginnings of a recession.

Thus, it was just a matter of time before the reduction of commitments, the fall in new orders, the weakness in commodity prices, and the general compression in timeframe of business decisionmaking would run out of room to contract. The normal forces of economic expansion would then reassert themselves, and indeed, this appears to be what is currently in progress.

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[1] See p. 277.

Real GNP through the first half of the current quarter appears to be tracking at something in excess of the 4 percent annual growth rate. This implies the continuation of the moderate inventory accumulation rate, which is now apparently underway.

If the inventory pace should accelerate, it is quite possible to get a much higher, say, 6 percent GNP growth rate for the current quarter.

NEAR-TERM OUTLOOK IS FAIRLY OPTIMISTIC

Accordingly, the near-term outlook is fairly optimistic. The lack of imbalances suggests that normal economic growth will take hold and carry us until imbalances are created. While the next 12 to 18 months seem reasonably secure, a number of unexpected events could derail the recovery.

The first is the possibility of an excessive surge of demand, built on large inventory accumulation, leading to credit stringency and eventually, a recession produced by a standard financial crunch. This does not seem particularly likely at the moment, especially since the tremendous pulling back of commitments to a near hand-to-mouth basis is reflective of a virtual elimination of inflationary expectations in the short term.

There is apparently little reason to accumulate inventories for potential capital gains. More likely is an eventual weakening of the dollar, which could develop into a speculative downturn in the exchange rate. This would in turn push short-term interest rates higher and stifle further economic growth.

It is difficult to assess the probability of this occurring in the short term, despite the indications that the current exchange rate, now probably close to 30 percent over purchasing power parities, is being driven by dollar demands which are unlikely to be sustained indefinitely.

The deepest shadow which crosses our otherwise benevolent economic scenario is cast by the structural budget deficit. Unless the laws of arithmetic are repealed, interest cost accumulation on top of $200 billion-plus deficits must inevitably crowd out private investment and economic growth.

However, it is not a short-term problem. Temporary market adjustments might fend it off for several years, but the process of deterioration is inexorable. While the strategic purpose of reducing the deficit is to prevent long-term excessive absorption of private savings and a crowding out of private investment, the short-term tactical purpose is to create in law a fiscal policy which the financial markets perceive as sufficiently credible to drive long-term interest rates down.

There is no need for a pact with the Federal Reserve, stipulating that if Congress reduces the deficit, the Fed will ease money supply. The markets work very efficiently by themselves. If the average cynical bond trader begins to perceive that indeed a budget reduction package is not phoney, the desire to turn a profit can be counted on to drive bond prices sharply higher and long-term interest rates correspondingly lower.

VIEWS DIFFER ON REDUCTION IN THE DEFICIT

There is clearly a difference, however, in the way bond traders and other participants in the world markets view a reduction in the deficit. A deficit reduction which is heavily weighted toward tax increases is less likely to induce the marked decline in interest rates than one heavily or solely weighted in the direction of expenditure cuts.

There is the strong presumption in the financial community that an increase in tax rates could just as easily become the base for increased expenditure programs as for reducing the deficit.

There is also clearly a difference in the way markets will react to the mix of Federal budget cuts between defense and entitlement programs. Leaving the politics of entitlements and the very serious question of defense adequacy aside, so far as the economy is concerned, does it make any difference where the cuts are made? I believe the short answer to that is that it does. Entitlements, Social Security, Medicare, civil service, military retirement and so forth depend to a significant extent on population growth, especially among the elderly.

As the base of expenditures expands, reflecting the growth in population, changes in the law today have a much larger impact on outlays 10 years from now than they do, say, 3 years from now.

Defense, however, is another matter. A goodly part of defense expenditures are involved in building up our military asset base. Once we reach the requisite number of F-16 wings, carrier task forces, ammunition stores, and so forth, procurement outlays will fall back to maintenance levels which are significantly lower in real terms than the huge budget outlays required during the period of military buildup.

Hence, cuts in defense over the next 3 years are not translatable, as they are in entitlement programs, into very much larger cuts in the years 1990 and beyond. Accordingly, the financial markets are surely likely to credit, on a dollar-for-dollar basis, short-term cuts in entitlement programs with far more long-term antiinflation impact than the equivalent cuts in defense outlays.

EXPENDITURE CUTS OF $100 BILLION NOT EXPECTED

There can be little doubt that the markets do not expect expenditure cuts ranging up to $100 billion or more annually by fiscal 1988. Should they actually occur, or, of more relevance, should they be enacted into law currently in a manner which is credible to the financial community, long-term interest rates are likely to fall by at least two full percentage points, with short-term rates falling even more.

Thus, even the sharp reduction in purchasing power implied by such a major contraction of Federal deficits, that is, so-called fiscal drag, would surely be overriden by increases in effective demand generated by the marked decline in interest rates and cost of capital.

Most immediately home building would rise quite significantly, increasing from recent levels of 1.7 million starts annually to well in excess of 2 million and perhaps considerably higher, at least for a while.

But the more important and lasting impact would occur in the capital goods markets. The exceptionally high cost of capital which has prevailed in recent years has led to a disproportionate emphasis in investment in short-lived assets—that is, those with quick cash payoffs. Lowered long-term interest rates would surely propel stock prices higher and lower the cost of equity capital. The combination of lowered costs of equity and debt would increase the incentive to invest in plant and other long-lived goods.

Considering the pent-up demand for long-lived investments at lower costs of capital, the expansion could go on for years. This would be especially helpful to those depressed areas of the American economy which build long-lived facilities for the materials which go into them—that is, steel, heavy equipment, and so forth.

POLITICAL SYSTEM HAS UNDERLYING BIAS TOWARD HIGHER SPENDING

The reason it is important to address the budget deficit now, rather than await the accumulation of interest, larger deficits, and more difficult periods of political and economic adjustment is that there is an underlying bias in our political system toward higher spending. Faced with nothing more than rhetorical concern, structural deficits would creep progressively higher.

It may be a cliche, but it is also an important political principle. Once a subsidy or preference becomes part of our budget and Internal Revenue Code, a constituency forms around it, nurturing it, supporting it, and implicitly threatening dire electoral consequences to the nonsupportive.

Most importantly, the combined cost of the rest of the rest of the electorate is sufficiently diffused and unfocused, that the value placed on the benefit by the select few appears to exceed, in units of political pressure, if one could measure them, the cost to the remainder of the electorate.

This is especially the case when the benefits or tax preference are funded through borrowing where the cost—that is, the potential inflationary consequences—is delayed, while the benefit is perceived as being received immediately.

I am of course merely describing the political process of which we have all become acutely aware in the last couple of generations. We take it for granted and perceive it as an integral part of our democratic process. It is, in fact, a dangerous underlying bias in our system, which threatens our democratic processes if not appropriately addressed. It was not an issue in the first 150 years of our Republic, because Government was not perceived as a redistributor of income and a creator of benefits through the fiscal system. Activist, redistributive, fiscal policy has been with us only for the last half century, but its effect has been cumulative.

Thus, while it is crucial to address the current budget problems and restore fiscal balance to our system, we should remember that we are only fighting the symptoms of a far more deepseated problem. It is essential to look beyond the short-term and into the structure of the system which created the problem, and which has been endemic in a world where central banks' money creation capacity is no longer even constrained by the supply of paper.

SUPER-MAJORITY REQUIREMENT NEEDED

While I subscribe to the principle of a balanced budget amendment with tax increase constraints, I believe that the expenditure process cannot be effectively stopped after constituencies have been formed and the corrosive effect of a whole series of seemingly costless benefits control the budget. I believe, as I have previously testified before this body, that to offset the bias in our political system, it is necessary to place in the Constitution a super-majority requirement for the passage of any money bill or authorization or entitlement to a claim on Federal revenues.

If, for example, we required a three-fifths majority of both Houses to pass any claim on Federal tax revenues, we would surely screen out a number of those programs perceived to be marginally desirable by the Congress and allow through only those which are of unquestioned priority to the Nation.

I suspect that even though such a change does not directly relate to balancing the budget, it will surely do so. This is especially likely if appended to a three-fifths majority vote requirement is mandatory sunset legislation which requires all programs with a claim on Federal finances to undergo reauthorization every 5 to 10 years. Sunset legislation stresses the importance of completely eliminating programs and hence, their constituencies.

Although sharp reductions in individual programs might seem to create large, long-term fiscal savings, it is usually tantamount to cutting off a weed at the root. The weed seems to be gone, but it is merely awaiting a more favorable environment to sprout and grow even larger.

In summary, the payoff in economic well-being for this nation from diffusing our chronic budgetary problems is so large relative to the short-term welfare and political costs, that it is inconceivable we will choose to trace a different course.

Thank you.

Chairman DOMENICI. Thank you very much, Dr. Greenspan.

[The prepared statement of Dr. Greenspan follows:]

Excerpts from the Testimony of Alan Greenspan*

Before the

Committee on the Budget
United States Senate
February 21, 1985

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While the preponderance of evidence suggests a fairly buoyant pattern of economic activity in the months immediately ahead, deep shadows hover over the longer term outlook. The recent pause in economic growth was a seemingly natural aftermath of the solid pattern of expansion during the first two years of recovery. This slowdown appears to be over, and a quickening pace of activity apparently is developing.

The improving outlook continues in the face of extraordinary strength of the U.S. dollar on foreign exchange markets. By creating price advantages for foreign-produced goods, the strong dollar has significantly increased the average share of imports to domestic demand in recent quarters. It has also diverted U.S. purchasing power to foreign producers and, at least in the simple first approximation, cost American production and jobs. But that first approximation is far from the whole story, however. The heavy demand for U.S. dollars has also left interest rates lower than they otherwise would have been and has clearly contributed to a lower rate of inflation. These in turn have lowered the sense of instability and risk associated with capital investment. It is thus unclear, on balance, how much of a job loss, if any, the strong dollar has produced.

What it has produced, without question, is a pattern of economic activity which is unique to the post World War II period and, perhaps, for a good deal of U.S. history before that. For the first time in many generations, our domestic output and employment are

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*Dr. Greenspan is President of Townsend-Greenspan & Co., Inc.

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being significantly impacted by events which originate outside our borders.

The impact of international trends was particularly pronounced last year. The tremendous expansion in consumer expenditures, which was triggered by pent-up demand in the summer of 1983, was finally exhausted by the summer of 1984. This inevitably brought with it a slowdown in economic growth. Growth in domestic purchases in real terms, that is gross national product minus net exports, slowed from a near 9% annual rate for the first six quarters of this recovery to a less than 6% annual rate in the third quarter of 1984. But the growth rate in domestic production, that is the gross national product, fell from 7% to less than 2% annually over the comparable periods. The additional slowing of GNP growth was a reflection of a greater volume share of imported goods -- presumably ordered earlier in 1984 -- arriving on our shores in time to displace a significant amount of domestic supply, production, and employment last summer.

The marked slowing in production, coupled with the weakness in dollar-denominated international commodity prices, also created a major squeeze on profit margins which, in conjunction with the dollar translation of foreign affiliate earnings of U.S. corporations, brought the rapid acceleration of profits in the first half of 1984 to an abrupt halt by the summer. Whereas after tax corporate profits during the first quarter of 1984 were a staggering 47% over the first quarter of 1983 it looks as though the current quarter's level of earnings will come in below those of a year ago. All of this created a tendency on the part of American business to adopt a somewhat defensive posture. The result was a dramatic contraction in purchases for inventory, and a sharp decline in the average lead time on the deliveries of materials from basic suppliers. In fact, with production materials being quoted with a lead time of only 50 days in December of 1984, purchasing patterns were back to their levels of the beginning of the 1983 recovery. This is an extraordinary phenomenon since a more typical pattern is one of considerable tightening of supply two years into a business recovery, prompting slowed deliveries, spot shortages, and rising commodity prices. Whatever one may say about the end of 1984, it was characteristic more of the beginning of a business recovery than its later stages.

The reason why the late 1984 pause in economic activity did not degenerate into another recession is that inventories remained exceptionally low by historical standards and capital investment was expanding. The period was scarcely describable in terms of an unsustainable boom, nor were there the clear credit stringencies which typically predate the beginnings of a recession. Thus it was just a matter of time before the reduction of commitments -- the fall in new orders, the weakness in commodity prices, and the general compression in the timeframe of business decision-making -- would run out of room to contract. The normal forces of economic expansion would then reassert themselves and, indeed, this appears to be what is currently in progress. Real GNP growth through the first half of the current quarter seems to be tracking at something in excess of a 4% annual growth rate. This implies continuation of the moderate inventory accumulation rate which is now apparently underway. If the inventory pace should accelerate, it is quite possible to get a much higher, say 6%, GNP growth rate for the current quarter.

Accordingly, the near-term outlook is fairly optimistic. The lack of imbalances suggests that normal economic growth will take hold and carry us until imbalances are created. While the next 12 to 18 months seem reasonably secure, a number of unexpected events could derail the recovery. The first is the possibility of an excessive surge of demand built on large inventory accumulation leading to credit stringency and, eventually, a recession produced by a standard financial crunch. This does not seem particularly likely at the moment, especially since the tremendous pulling back of commitments to a near hand-to-mouth basis is reflective of a virtual elimination of inflationary expectations in the short term. There is apparently little reason to accumulate inventories for potential capital gains.

More likely is an eventual weakening of the dollar, which could develop into a speculative downturn in the exchange rate. This would, in turn, push short-term interest rates higher and stifle further economic growth. It is difficult to assess the probability of this occurring in the short-term, despite the indications that the current exchange rate, now probably close to 30% over purchasing power parities, is being driven by dollar demands which are unlikely to be sustained indefinitely.

The deepest shadow which crosses our otherwise benevolent economic scenario is cast by the structural budget deficit. Unless the laws of arithmetic are repealed, interest cost accumulation on top of $200 billion plus deficits must inevitably crowd out private investment and economic growth. However, it is not a short-term problem. Temporary market adjustments might fend it off for several years, but the process of deterioration is inexorable.

While the strategic purpose of reducing the deficit is to prevent long-term excessive absorption of private savings and a crowding out of private investment, the short-term tactical purpose is to create, in law, a fiscal policy which the financial markets perceive as sufficiently credible to drive long-term interest rates down. There is no need for a pact with the Federal Reserve stipulating that, if Congress reduces the deficit, the Fed will ease money supply. The markets work very efficiently by themselves. If the average cynical bond trader begins to perceive that indeed a budget reduction package is not phoney, the desire to turn a profit can be counted on to drive bond prices sharply higher and long-term interest rates correspondingly lower.

There is clearly a difference, however, in the way bond traders and other participants in the world markets view a reduction in the deficit. A deficit reduction package which is heavily weighted toward tax increases is less likely to induce a marked decline in interest rates than one heavily or solely weighted in the direction of expenditure cuts. There is the strong presumption in the financial community that an increase in tax rates could just as easily become the base for increased expenditure programs, as for reducing the deficit. The argument that the Congress has not in the past employed tax increases to finance increased expenditures is apparently unpersuasive to the financial community. The past is likely to tell us little about the future behavior of the Congress when confronted with pressures from constituencies.

It is true that Presidents and the Congress continuously cut tax rates through the 1970s as inflation pushed most taxpayers into progressively higher tax brackets. Hence, federal receipts as a percent of the GNP or of taxable incomes has remained relatively steady during the past couple of decades. It is argued, therefore, that increased tax receipts have not been the basis for financing new outlay programs. The critical consideration, however, is spending, which rose as a ratio to GNP, increasing the structural deficit. Unless the upward pressure on spending is reduced, tax increases will eventually be triggered, since deficits can't increase indefinitely. In that event, taxes are supporting increased spending programs, albeit with a time lag.

There is also clearly a difference in the way markets will react to the mix of federal budget cuts between defense and entitlement programs. Leaving the politics of entitlements and the very serious question of defense adequacy aside, so far as the economy is concerned, does it make any difference where the cuts are made?

The short answer is that it does. Entitlements: social security, Medicare, civil service, military retirement, etc., depend to a significant extent on population growth, especially among the elderly. As the base of expenditures expands, reflecting the growth in population, changes in the law today have a much larger impact on outlays ten years from now than they do, say, three years from now.

Defense, however, is another matter. A goodly part of defense expenditures are involved in building up our military asset base. Once we reach the requisite number of F-16 wings, carrier task forces, ammunition stores, etc., procurement outlays will fall back to maintainance levels, which are significantly lower in real terms than the huge budget outlays required during the period of military build-up. Hence, cuts in defense over the next three years are not translatable, as they are in entitlement programs, into very much larger cuts in the years 1990 and beyond.

Accordingly, the financial markets are surely likely to credit, on a dollar for dollar basis, short run cuts in entitlement programs with far more long-term anti-inflation impact than equivalent cuts in defense outlays.

There can be little doubt that the markets do not expect expenditure cuts ranging up to $100 billion or more annually by fiscal 1988. Should they actually occur, or of more relevance should they be enacted into law currently, in a manner which is credible to the financial community, long-term interest rates are likely to fall by at least 2 full percentage points with short-term rates falling even more. Thus, even the sharp reduction in purchasing power implied by such a major contraction of the federal deficits, i.e. so-called fiscal drag, would surely be overridden by increases in effective demand generated by the marked decline in interest rates, and cost of capital.

Most immediately, homebuilding would rise quite significantly, increasing from recent levels of 1.7 million housing starts annually to well in excess of 2 million and perhaps as high as 2.2 million units annually, at least for awhile. But the more important and lasting impact would occur in the capital goods markets. The exceptionally high cost of capital which has prevailed in recent years has led to a disproportionate emphasis in investment in short-lived assets, i.e., those with quick cash payoffs. Lowered long-term interest rates would surely propel stock prices higher, and lower the cost of equity capital. The combination of lowered costs of equity and debt would increase the incentive to invest in plant and other long-lived goods. Considering the pent-up demand for long lived investments at lower costs of capital, the expansion could go on for years. This would be especially helpful to those depressed areas of the American economy which build long-lived facilities or the materials which go into them -- steel, heavy equipment, etc.

The reason it is important to address the budget deficit issue now rather than await the accumulation of interest, larger deficits, and more difficult periods of political and economic adjustment is that there is an underlying bias in our political system toward higher spending. Faced with nothing more than rhetorical concern, structural deficits would creep progressively higher.

It may be a cliche, but it is also an important political principle. A particular subsidy or tax preference may be something which the nation has gotten along without for a couple of hundred years and, seemingly, could do without for another couple of hundred years. Once a subsidy or preference becomes part of our budget and Internal Revenue code, however, a constituency forms around it, nurturing it, supporting it, and implicitly threatening dire electoral consequences to the nonsupportive. Most importantly, the combined cost to the rest of the electorate is sufficiently diffuse and unfocused that the value placed on the benefit by the select few appears to exceed in units of political pressure, the cost to the remainder of the electorate. This is especially the case when the benefits or tax preferences are funded through borrowing where the cost, i.e., the potential inflationary consequences, is delayed, while the benefit is perceived as being received immediately.

I am, of course, merely describing the political process of which we have all become acutely aware in the last couple of generations. We take it for granted and perceive it as an intergral part of our democratic process. It is, in fact, a dangerous underlying bias in our system which threatens our democratic processes if not appropriately addressed. It was not an issue in the first 150 years of our republic because government was not perceived of as a redistributer of income and a creator of benefits through the fiscal system. Activist, redistributive, fiscal policy, has been with us only for the past half century but its effect has been cumulative.

Thus, while it is crucial to address the current budget problems and restore fiscal balance to our system, we should remember that we are only fighting the symptoms of a far more deep seated problem. It is essential to look beyond the short-term and into the structure of the system which created the problem, and which has been endemic in a world where central banks' money creation capacity is no longer even constrained by the supply of paper.

While I subscribe to the principal of a balanced budget amendment with tax increase constraints, I believe that the expenditure process cannot be effectively stopped after constituencies have been formed and the corrosive effect of a whole series of seemingly costless benefits control the budget.

I believe as I have previously testified before this body, that to offset the bias in our political system, it is necessary to place in the constitution a super-majority requirement for the passage of any money bill or authorization or entitlement to a claim on federal revenues. If, for example, we required a three fifths majority of both Houses to pass any claim on federal tax revenues we would surely screen out a number of those programs perceived to be marginally desirable by the Congress and allow through only those which are of unquestioned priority to the nation. I suspect that even though such a change does not directly relate to balancing the budget, it will surely do so. This is especially likely if, appended to a three fifths majority vote requirement, is mandatory sunset legislation which requires all programs with a claim on federal finances to undergo reauthorization every five to ten years.

Sunset legislation stresses the importance of completely eliminating programs and, hence, their constituencies. Although sharp reductions in individual programs might seem to create large long-term fiscal savings, it is usually tantamount to cutting off a weed at the root. The weed seems to be gone, but it is merely awaiting a more favorable environment to sprout and grow even larger.

In summary, the payoff in economic well being for this nation from defusing our chronic budgetary problems is so large relative to the short-term welfare and political costs, that it is inconceivable we will choose to trace a different course.

Chairman **Domenici**. Senator Chiles, we started without opening remarks because we were all late, including the Chairman. I will proceed with the other witnesses, unless any of you have a desire to inquire.

If there is none, we will then proceed.

Dr. Dornbusch, we welcome you here, and we look forward to your testimony. We have received your prepared remarks, and they will be made a part of the record.[1]

STATEMENT OF DR. RUDIGER DORNBUSCH, FORD INTERNATIONAL PROFESSOR OF ECONOMICS, MASSACHUSETTS INSTITUTE OF TECHNOLOGY

Dr. **Dornbusch**. Thank you very much, Mr. Chairman.

I would like to use my time to briefly summarize my written statement. The basic point I would like to make is that there are three good reasons to cut the budget—first, that ultimately, it will have to be done, and now is easier than later; second, that the failure to cut it now affects adversely the U.S. productive structure, particularly from an international point of view, and that would make in the longrun budget cutting more difficult than it is now; and last, that budget cuts soon would improve the world economy very substantially, and that would make it easier for us to live with the cuts in budgets.

I want to focus on the international aspect of the budget, as I have been asked by the staff.

I want to first raise the question why the dollar is high, and I think that has some bearing from a budget point of view, and then investigate what are the effects on the U.S. economy; what are the effects abroad; what would be a reasonable macropolicy in case of budget reduction. If budgets are not cut, are there quick-fix remedies for the internationally adverse effects of our deficits that should be considered—and the answer to that last question is no.

DOLLAR IS HIGH BECAUSE OF FISCAL DESYNCHRONIZATION

The first issue—why is the dollar high. The popular argument is that the United States is just a much better place to put your money—the safe haven and superior management argument. It is very hard to accept that argument. If anyone studies international capital flows, they really cannot persuade themselves that the money goes to the places that are really best managed.

If we look at the international debt crisis, Latin America found it very easy to get $50 or $70 billion a year, for economies which we now say were terribly managed. In fact, they were exactly managed like the U.S. economy now. Argentina and the U.S. economy are exactly the same—big budget deficits, overvalued exchange rates, high interest rates that pay people to bring their money. There is no difference there.

It might be argued that the possibility of a world war is more proximate, and therefore you put your money into the United States I cannot evaluate that argument. But superior management clearly is not the case.

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[1] See p. 291.

I think a more serious argument for a high dollar is unambiguously the policy mix that we have been pursuing relative to the rest of the world. In the United States over the last 4 years, we have moved in the direction of a large budget deficit. In the rest of the world, most industrialized countries have moved exactly in the opposite direction.

I can direct your attention to my testimony on page 4.[1] I show data for the cyclically and inflation-adjusted budgets of the United States, Europe, and Germany. Our budget moved by almost 5 percent in the direction of a deficit. In Germany, the move was 4 percent toward a surplus, and in Japan, 3.2 percent.

Everything that we can say of the U.S. budget, we can say with the signs reversed of foreign budgets. There has been an unprecedentedly large shift in the relative fiscal positions, not only our deficits, but also their shifts to surpluses. Their shifts have been exactly as large as ours. That has been supplemented by a tight money policy in the United States relative to the rest of the world.

Of course, our interest rates have been falling over the last year, relative to those abroad, but it remains true that our interest rates are higher than abroad. People who bring their money here get paid a differential, even if the differential falls.

Now interest rates will be rising, and this differential goes up again. I think it is not hard to understand that the world's capital is coming to the United States as long as there is a differential. In fact, as long as their is a differential, we also should persuade ourselves that there is nothing superior to U.S. assets. A bank that pays more in all likelihood is a bank that has a problem. In the same way, with the United States, paying an interest differential, paying more than Germany or Japan, one will have to ask why is it that people require more to hold U.S. assets? There must be something wrong with us. Superior management means you can borrow for less.

So on the issue why is the dollar high, I conclude that it is the fiscal desynchronization.

Senator **Chiles**. What was that?

Dr. **Dornbusch**. The asymmetric move in fiscal policy in the United States toward expansion abroad in the last 5 years toward contraction.

SPECULATORS ARE SAFE HOLDING U.S. ASSETS

I would like to go a step ahead and state that if people anticipated that there were a correction, and with that the interest rates would come down, the dollar would come down, why do they hold U.S. assets with that risk in mind? I believe the public does not expect that there is a large change in the relative fiscal policies, and therefore, that there is no likelihood of a large collapse of the dollar.

But if the dollar does not collapse, then the interest differential pays for the risk of a small decline.

I would also think that the situation in the rest of the world, particularly in Europe, is not such that they would like to see the dollar coming down. The decline in oil prices reduces any inflation problems that they have. In fact, in Germany, the GNP deflator has been flat; they have no inflation problems. Therefore, they would not need imported disinflation. If the dollar came down in a big way, the EMS might break up. So Europe is not looking to a strong dollar. Our deficits will not go away. Any speculator is safe holding U.S. assets, and that is why the U.S. dollar is strong.

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[1] See p. 295.

Now I want to look at what the strength of the dollar involves. There are several things to look at—our trade performance, the effect on our inflation, on our terms of trade, and on our growth.

On trade performance, if I can direct your attention in my statement to figure 2 following page 6,[1] this shows the U.S. current account deficit. The striking fact, of course, is that our deficit has moved on current account to a deficit equal to 3 percent of GNP where it used to be balanced. I will have to explain that.

THERE ARE HUGE CHANGES IN COMPETITIVENESS

The loss of external competitiveness is certainly a factor. It is very difficult to put a number on it, because we can look at the basket of currencies, we can adjust for inflation. We will have numbers ranging from 20 to 40 percent. I give in my statement details. Looking at export prices of narrowly defined manufactured commodities you will find that the loss in competitiveness over the last 4 years, compared to Japan, is of the order of 30 percent, and relative to Germany and Europe at large, of the order of 50 percent. These are huge changes in competitiveness, much larger than what we talk about in commercial policy when we see a 5- or 10-percent tariff—very large changes in competitiveness.

The question is, is that the main explanation for our deterioration in the external balance, or should we see other reasons.

There are two other important reasons. One is that we have cyclically been entirely out-of-line with the rest of the world. We had very strong growth; the rest of the world had growth that was much weaker. As a consequence, our imports have been growing very rapidly. Our exports have been doing more poorly. But more important, still, than the behavior of the economies of the industrialized countries has been the collapse of Latin America—the change in Latin America's trade surpluses is of the order of 1.5 percent of U.S. GNP, and a good part of that improvement in Latin America's trade performance has been at our expense and shows up in our current account deterioration.

I show in my statement on page 7 [2] data on the volume of export and import growth over the last 3 years. And what I would like to point out is the big asymmetry between U.S. exports falling 15 percent, U.S. imports growing 21 percent—that is our large deficit—and exactly the opposite pattern happening in Europe—large export growth, no import growth—in Japan, extra large export growth to the U.S. markets, no import growth; in Latin America, huge export growth to the U.S. markets, and an absolute decline of 30 percent in their imports.

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[1] See p. 298.

[2] See p. 300.

The volume growth reflects not only competitiveness; it is also that we have been recovering strongly, and the rest of the world has not or actually gone into depression, as Latin America has.

HIGH DOLLAR HELPED ACHIEVE REDUCTION IN INFLATION

On the domestic side, there are some big advantages from the high dollar. The strongest advantage is in the rapid reduction in inflation that it has helped achieve.

It is not certain from the evidence what exactly the effect of exchange appreciation is on inflation. The rule of thumb is that a 10-percent appreciation will reduce the inflation rate by 1 percent. But in work I have done, I find that a 10-percent appreciation, working separately through prices and through wages, may bring as much as a 2-percent reduction in inflation.

There is considerable evidence now that in the U.S. labor market there is a strong softening of contracts. You can say it is deregulation, you can say it is the labor costs, you can say it is the dollar. The three add together to give us an inflation rate and a rate of increase of labor settlements that is extremely unusual for this stage of the recovery. The strong dollar certainly was part of it, and therefore, it is one of our problems if the dollar should come down; we will have to repay what we already got.

REAL INCOME TRANSFER RECEIVED FROM REST OF WORLD

The second effect in the U.S. economy of the strong dollar is on the side of terms of trade. Our export prices have been rising relative to our import prices. We received a real income transfer from the rest of the world of the order of 1 percent a year. That is something we will have to give back when the dollar falls. We have received that real income transfer through reductions in our import prices. Commodity prices in world trade have been falling, so we have had cheap access to commodities, including oil; our export prices have increased a lot, relative to our import prices. That is the way we have collected the transfer, and that has meant that we could have real wage gains that were noninflationary, and that may well have been an important aspect of our recovery.

The last point I want to raise is the effect of the strong dollar on U.S. employment. Certainly, if we look at the comparison between the United States and Europe, our employment growth has been very impressive. But if we look at what has been happening in manufacturing, that is not true. Since 1979, there has been absolute decline in manufacturing of 6 percent—more than 6 percent. We might say that the U.S. economy is turning toward a service economy, and all we are seeing is aggregate employment rising and manufacturing shedding labor to provide the resources for other sectors to grow. You might say that slack in the economy is responsible for shifts in demand, any of a number of reasons.

But when we are through, the fact is that the strong dollar has caused a lot of unemployment in U.S. export industries and in import-competing industries, and that is a very serious issue, because firms that are trade-related are going bankrupt. When the dollar comes down ultimately, those firms will not be there, and therefore the jobs will not be there, and therefore, our adjustment difficulties will be much larger.

If the dollar never were to come down, we should not worry about trade-related manufacturing, that is, an industry that should disappear. If we expect that the dollar will come down, then we do want those industries ultimately to be there, and then we should worry about the dollar now.

STRONG RECOVERY HAS BEEN OF SUBSTANTIAL BENEFIT EVERYWHERE

I want to next talk about the international effects, or the effects abroad, of our macro economic policies. It is quite clear that our very strong recovery last year has been of substantial benefit everywhere. Japan has been able to have both growth and a strong reduction in their budget deficits as a consequence of our budget deficit, and the same is true of Europe. I showed before the budget data for Germany and Japan. They have moved nearly to balanced budgets with the help of export-led growth. So we have been exporting that benefit to industrialized countries, and in the same way, to LDC's.

The debtor LDC's that, a year or two ago, were in crisis, in fact have experienced extremely strong export growth that helped them pay the interest.

It was expected that in the recovery, OECD growth would be strong, the dollar would collapse, interest rates would fall. Half of that has been true. The growth was strong. Interest rates have not come down below the 10 percent level of 1983, and the dollar certainly has not collapsed. So the adjustment problems for LDC's in fact have been more serious than anticipated. They have not been able to pay off their debts or service their debts out of capital gains and low interest rates. They actually had to work hard for it. But from a financial point of view, from the external point of view, they have been able to pay; had we had a recession, they would not have been able to.

But we also have to bear in mind, when we say they have been able to pay, what is happening in their domestic economies. There is no question that there is a deep recession all over Latin America. Their per capita income has fallen between 12 and 15 percent, and nobody expects that before 1990, they will be back where they were in 1980. So there are enormous domestic effects. And if we are told there was growth last year, there was also growth in the United States in 1934, because from the bottom, you really only can go up. But so far, they are not anywhere near where they were in say 1977–78.

I want to come next to the budget options, and simply say that there are two arguments on the domestic side to cut the budget. We run deficits, and ultimately, we have to run larger surpluses. If it is now difficult to cut the budget, and there is no expectation that the world is changing to make that easier—and there is really none—then tomorrow, we will have to cut the budget even more. That is the simple argument to start now.

HOW CUTTING THE BUDGET WOULD AFFECT WORLD ECONOMY

The second argument relates to the world economy, and here, we want to ask what will happen if we cut our budget. The Federal Reserve would assume a more expansionary stance; the real interest rate would come down, and abroad, real budget deficits would be reduced. We look at Europe, and a major part of the budget deficit is the interest bill. If the dollar came down, Europe would take down interest rates. They would take down interest rates because they really do not want to lose the foreign trade-related employment. So we would have a decline worldwide in interest rates; therefore, a worldwide decline in interest charges in the budgets. There would be immediately relief on the budgets.

The Europeans could respond by some fiscal expansion. That is very urgent in Europe because unemployment today is twice at the level where it was only 5 years ago, and it is forecast to be rising.

Europe thinks that they are in an impasse. They cannot take down the interest rate with a strong dollar, because the dollar would be even stronger. They feel they cannot expand their budgets, because they have a longstanding fiscal problem. So all they can do is enjoy export-led growth.

If we corrected our budget, and interest rates came down in the United States, they would come down abroad; there would be fiscal expansion abroad, and we would have a continuation of the recovery more on a worldwide basis, less financed in the United States and more shared abroad.

I think that is a very strong international case, and certainly, one that extends to the LDC's.

CUTTING THE BUDGET IS THE EXACT POLICY MIX

If the budget were cut, there would be a moderate decline of the dollar, perhaps 10 to 15 percent, certainly not 30 or 40 percent. The moderate decline of the dollar would raise prices in world trade, and that will help LDC's service their debt. The decline in interest rates will help them. The continuation of growth will help them. So it is exactly the policy mix that, at this stage of the recovery, is essential for the U.S. economy and for the world economy.

Now, if I were a skeptic about the chances for budget improvement, then one would have to ask are there other things that should be done for U.S. manufacturing, pending the slow process of turning the budget around; is there a way of taking the dollar around or improving competitiveness for manufacturing, leaving aside fundamentals of macroeconomics. I think there is none.

We could use sterilized intervention, but it is well established that it does not do anything. We could, second, use a uniform import tariff. That would be a terrible idea. It would be a terrible idea because the rest of the world is waiting for a chance to use protection. We would have worldwide protection; our export industries would have even more trouble than they have now. They would not only have slow growth abroad, the collapse of Latin America, they would even lose market access. So, while it helps importers; it would be a tax on exporters.

The respectable argument, if the dollar is too high, is to use taxation of capital flows. If foreigners think they are getting excess returns in the United States, and capital flows in, driving up the dollar, then we should tax those returns, reduce the benefits, and turn the capital around. The question is, Is that a good idea without any macroreform. If the dollar came down now, then we would have, on top of the excessive fiscal ease, improvement in the external balance; we would have stronger growth, higher interest rates, the decline in the dollar would push up inflation. We would have a bit of the worst of all worlds.

So, we certainly on no account can avoid cutting the budget. From a longrun point of view, the United States needs manufacturing, and that means manufacturing has to be competitive, the dollar has to come down somewhat. We have the choice whether manufacturing is employed primarily by strong growth in the world economy or by a sharp reduction in the dollar, and a much better option is some decline in the dollar, strong growth abroad. The United States cut in the budget would make that possible.

Thank you.

Chairman Domenici. Thank you very much, Dr. Dornbusch.

[The prepared statement of Dr. Dornbusch follows:]

Revised
February 1985

DOLLARS, DEBTS, AND DEFICITS*

Rudiger Dornbusch

Massachusetts Institute of Technology

The U.S. economy is performing strongly, with low inflation, and sustained growth of output and employment. But the performance is overshadowed by record-high budget deficits, an overvalued currency, and a growing external imbalance. All the world's money is coming to finance the spectacle. Europe is green with envy and baffled dumb at how reckless spending can produce record growth. Latin America is confused whether to lament high interest rates and a strong dollar, or applaud the U.S. import boom. Japan is quietly enjoying export-led recovery and budget balancing. Although the recovery so far has been immensely successful the question of engineering a soft landing becomes increasingly important.

In my comments I will address the international aspects of the U.S. budget deficit. Specifically I will discuss how the deficits affect the dollar and thereby U.S. international competitiveness as well as our inflation performance. I will also consider what bearing the deficits have on the ability of LDCs to service their debts. A year ago international considerations seemed to make correction of our deficits a topmost priority; the dollar was expected to collapse under the weight of our external deficits and our competition for the world's saving to raise interest rates beyond what debtors could pay.

But now, a year later, the dollar is still rising and debtors are still, and more easily, paying. The urgency seems to be gone and it is tempting to look for remedies against the effects of the high dollar while the inevitable task of budget cutting gets slowly underway. I will review some of the alternative options to restore competitiveness and discuss whether they can be effective without more basic changes in our fiscal policy.

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*Statement before the Senate Budget Committee, U.S. Congress, February 21, 1985.

I will argue that there are three good reasons to start the process of cutting deficits now. First, cutting the deficit is ultimately unavoidable. But delaying the adjustment means that even larger and more painful adjustments will be required in the future. Because there is no reason to believe that in the future it will be easier to make corrections, we should start while it is still relatively easy. The second argument has to do with the erosion of international competitiveness due to exchange rate overvaluation. The standard crowding-out argument is that budget deficits that finance consumption displace capital formation, and thereby ultimately reduce potential output and the standard of living. This argument becomes much more forceful when we observe that the deficits lead to exchange appreciation and a loss of competitiveness that causes firms in the international sector to go out of business or move abroad. This represents an immediate and direct reduction in potential output which is larger and more pervasive, the longer we expose manufacturing to overvaluation.

Finally, at this stage of the recovery, fiscal tightening in the U.S. and compensating monetary expansion will cause the dollar to decline and interest rates to fall world-wide. Foreign governments who will lose some of their export-led growth will then have to relax excessively tight fiscal stance. That would stretch out the recovery and reduce world-wide unemployment from the still very high levels.

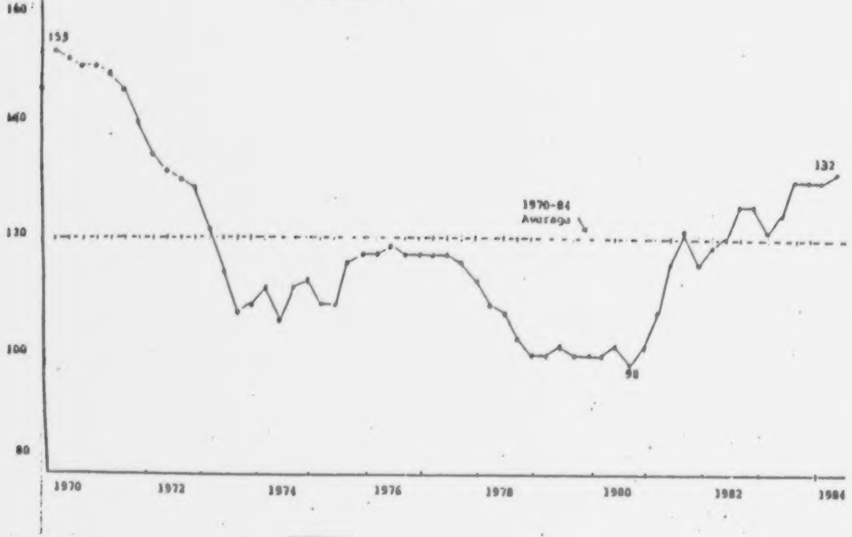
1. Why is the Dollar High?

Just in the last two months the dollar has appreciated by more than 5 percent against major foreign currencies. Since 1979 the dollar has been on an almost uninterrupted rise in world currency markets. Against the Yen the appreciation has been nearly 20 percent; it has been almost 75 percent against the Deutsch Mark, and nearly 100 percent against Sterling. Even though inflation adjustments, in some cases, translate these numbers into smaller changes in real exchange rates the appreciation remains huge.

Figure 1 shows the inflation-adjusted exchange rate which measures U.S. competitiveness in manufacturing. It is a useful starting point for a discussion of overvaluation. Compared to the 1970-84 average there has been relatively little appreciation, only around 10%. Of course by comparison with the rock bottom of 1979-80 the deterioration in our competitiveness is more nearly 30 percent.

There are three main arguments for the strength of the dollar. The first is the safe haven and superior management argument. In an uncertain world, the U.S. is a relatively better place to park one's assets. Perhaps there is some merit to this argument, but surely not much has changed since 1981 unless there is a feeling that war is more likely than only a few years ago. Large changes have taken place in Latin America, justifying capital flight from there, but the same argument would not apply to Europe or Japan. The argument of superior management is decidedly more precarious. It is true that in the U.S. labor has weakened and deregulation has been on the rise for a decade. At the same time, however, our lax fiscal policy is exactly of the same kind that led to the collapse of the Franc in Mitterand's expansionary phase. Viewed as superior management, the U.S. performance looks good in

Figure 1
THE U.S. REAL EXCHANGE RATE
(Index 1980=100)



terms of unemployment and investment, but not in regard to fiscal discipline.

The more basic argument for the strong dollar resides in the worldwide constellation of fiscal policy. In the U.S. we have tight money and very easy fiscal policy. Abroad monetary policy has been perhaps as tight, but fiscal policy has been on a course of relentless tightening. Moreover, there is little prospect of a reversal of these patterns in the near future. The move of fiscal policy in opposing directions can be judged from Table 1.

Table 1 General Government Budget Trends
(Percent of GDP)

	Actual Budget 1984	1985*	Change in Adjusted Budget Deficit: 1980-85
U.S.	-3.2	-3.6	-4.5
Germany	-1.7	-0.9	+4.2
Japan	-2.2	-0.8	+3.2
Non-US OECD	-4.0	-3.2	+1.7

*Forecast
Source: OECD.

While the U.S. deficit (adjusted for the business cycle and inflation) deteriorated by more than four percentage points, other major industrialized countries achieved an important reduction of their deficits. In particular Germany and Japan now have unadjusted budgets that are nearly balanced. Their cyclically adjusted budgets show significant surplusses. These opposing directions of fiscal policy imply a shift in demand toward U.S. goods, increased absorption of resources in the U.S. and hence a rise in the relative price of U.S. goods. The real appreciation of the dollar brings about that increase in relative price.

In financial markets the dollar is, for the moment, sustained by an interest differential in favor of U.S. assets. The differential has come down, but it remains quite substantial (more so on longdated securities) and compensates for the risk of some depreciation unless there is an outright chance of a major dollar collapse. The increasing likelihood that relative fiscal positions will not be reversed makes the chance of a collapse look small and hence the interest differential large. This argument is reinforced by the fact that the rest of the world needs the U.S. trade deficits to support their output and employment, and would in all likelihood respond to an incipient collapse of the dollar by cutting interest rates to maintain the dollar substantially in its present position. We return to the likely course of the dollar in discussing budget strategies below.

2. The Dollar and U.S. Trade Performance.

U.S. exports have been performing poorly and imports have increased steeply. The net effect has been a sharp deterioration of the external balance. We now look at the three chief sources of that deterioration, namely the dollar, our rapid expansion relative to other countries and the collapse of Latin America.

The loss in competitiveness since 1979-80 is as impressive as the previous gain in the early 1970s, when the fixed exchange rate system collapsed. Interestingly, that deterioration has taken place much more relative to Europe and the LDCs than in relation to Japan. Table 2 shows the comparison by looking at the changes in export competitiveness for particular manufactured items.

Table 2 U.S. Loss of Export Competitiveness in Manufacturing
(Cumulative Percentage Change of Dollar Prices: 1980-84:I)

	U.S.	Japan	Germany
Machinery and Transport Equipment	20.0	-3.9	-19.5
Electrical Machinery, Apparatus and Appliances	22.7	-1.0	-22.4
Non-Electrical Machinery	13.1	-8.0	-19.6

Source: UN Monthly Bulletin of Statistics.

The striking fact, of course, is that competitors prices in dollars actually fell while U.S. prices have been increasing substantially. The net loss in competitiveness relative to Japan for the 1980-84:I period is of the order of 30 percent. Relative to Germany (and Europe) the U.S. lost about 50 percent.

The diagnosis of overvaluation does not seem difficult to make. The external balance, as shown in Figure 2, has deteriorated over the past two years from a small surplus to a 1984 record deficit of nearly three percent of GNP. The overvaluation view certainly would be reinforced when we look in Figure 3 at the behavior of U.S. export and import volume. But that would be attributing too much of an effect to competitiveness, disregarding the strong impact on the external balance of divergent cyclical movements here and abroad. It is an established fact that our external balance will deteriorate when the U.S. grows rapidly relative to the rest of the world. Conversely,

Figure 2
The U.S. Current Account
(Percent of GNP)

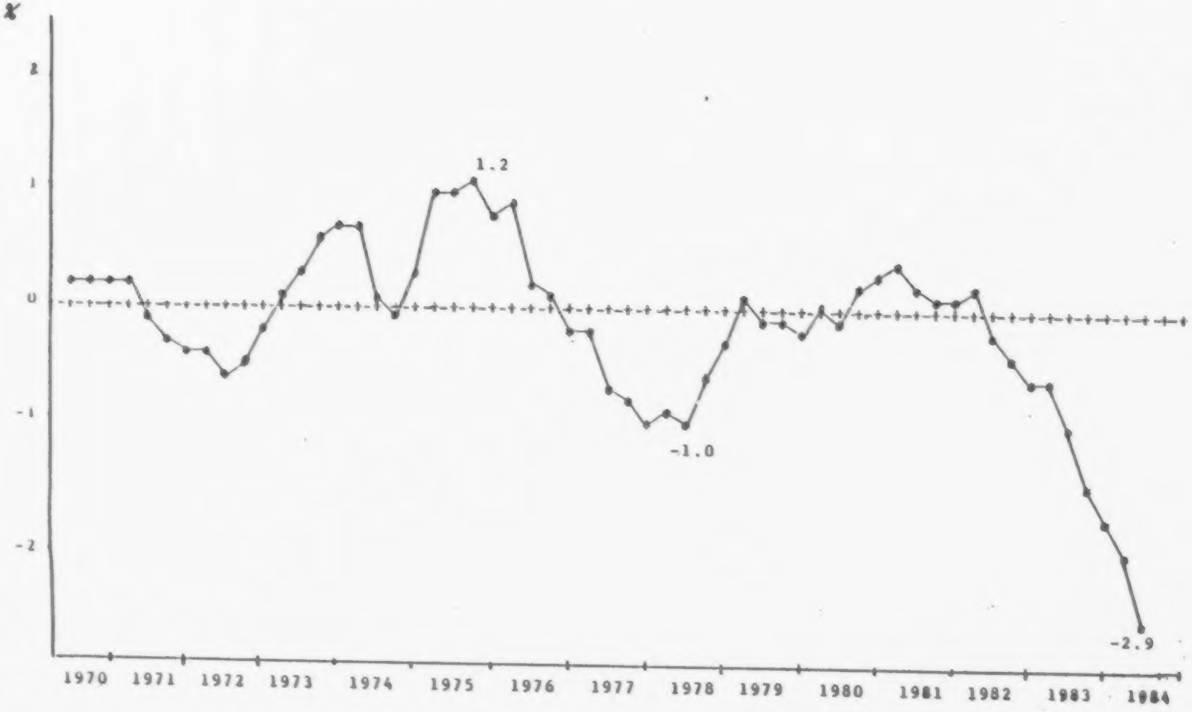
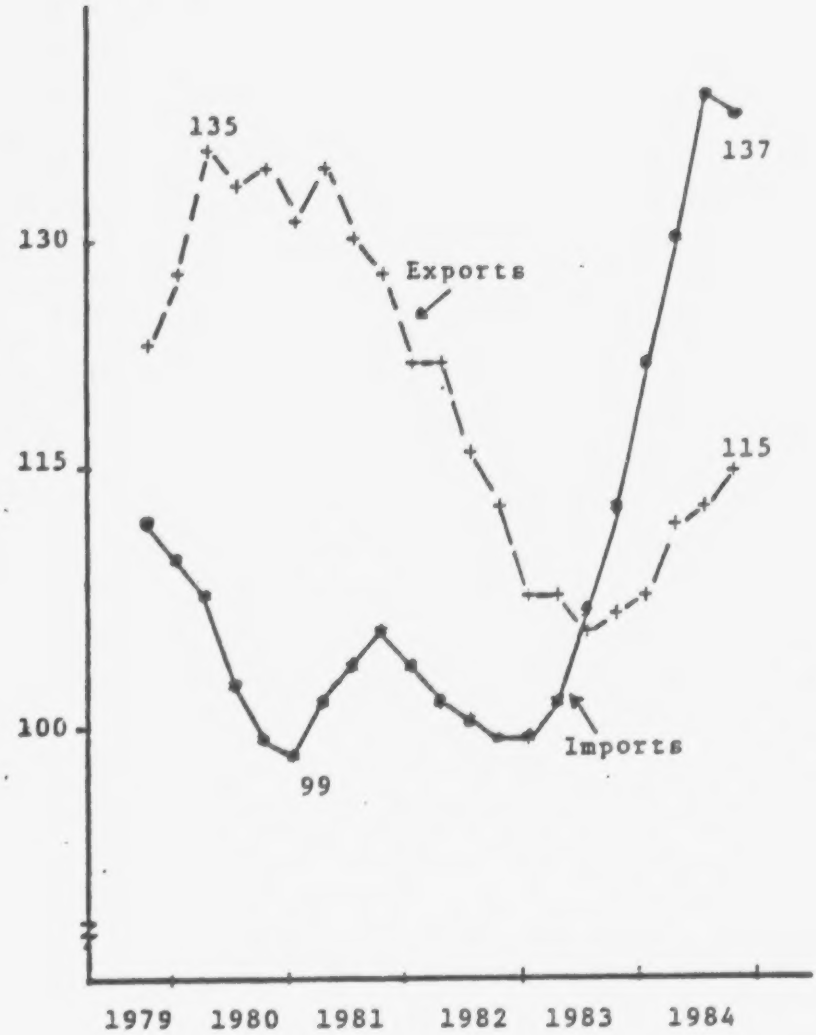


Figure 3
U.S. Export and Import Volume



our external balance improves relative to trend when our economy slows down more than is the case abroad.

These cyclical effects are important in the 1983-84 case because they are large and work in the same direction as the overvaluation. The trough of our recession was in 1982:4, and since then activity in the U.S. has increased relative to that in major industrialized countries by more than 10 percent. Our imports have grown rapidly (See Figure 3) as a consequence of the combined influence of our rapid demand expansion and our reduced competitiveness. Our exports have declined absolutely compared to 1979-80, and their recent recovery is so moderate because of slow demand expansion abroad and sharply increased foreign competitiveness.

The debt crisis of developing countries which started in 1982 has amplified our external balance deficit. Debtor countries were forced to cut down on their imports and seek expansion of export revenue. This adjustment has contributed to the deterioration of our external balance. The magnitude of the adjustment is brought out by the fact that in 1983 our exports to Latin America were 40 percent below their 1981 level. Table 3 illustrates how cyclical factors and competitiveness have worked in opposing directions for the U.S. and for foreign countries.

Table 3 Change in Trade Volume
(Cumulative Percent Change: 1981-84)

	U.S.	Europe	Japan	Latin America
Exports	-15.0	15.0	30.3	26.4
Imports	21.0	6.2	5.0	-31.6

Source: IMF World Economic Outlook.

The change in relative cyclical positions combines with the ongoing adjustment to our loss in competitiveness to explain how our external balance deteriorated by more than 3 percent of GNP in only two years. It is difficult to separate out empirically the exact contribution of cyclical and competitive effects. But as a rough estimate it can be argued that if relative cyclical positions and external competitiveness in 1983-84 had been at their average levels of the 1970-84 period the current account today would still show a deficit of about 1 to 1.5 percent of GDP rather than 3 percent.[1] That difference is perhaps due in equal parts to the loss in competitiveness and to our cyclical advance, although that breakdown is quite uncertain.

3. Domestic Effects of the High Dollar.

We saw above the deterioration of the U.S. external balance as one of the effects of the U.S. loss in external competitiveness. We now discuss in more detail the effects of the strong dollar. The dollar appreciation has three main effects on the U.S. economy:

- inflation is reduced,
- profitability and employment in the export sector and in import competing industries are reduced, and
- U.S. real income is raised due to the favorable terms of trade movement.

Inflation: It is well-known that a devaluation in a small country has a substantial impact on the price level. A large part of imports enter directly in the consumer price index and the same is true on the export side. Moreover, there will be some spill-over of the increase in prices of traded goods to domestic goods that directly compete with tradeables. Finally, wages will to some extent increase to make up for the increased cost of living. In a small open economy it is not surprising to find that a twenty percent devaluation raises prices as much as 10 or even 15 percent. In fact care must be taken that the price increase does not match completely the devaluation, as would surely be the case if the economy were extensively indexed.

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[1] This calculation is based on an econometric equation that explains the current account as a fraction of GNP by the real exchange rate, relative activity, and a time trend. The time trend explains why the 1984 deficit ratio would be more than a percentage point larger than the average deficit in 1970-84 of 0.16 percent.

In the U.S. economy, quite contrary to this case, it used to be thought that world prices had little effect on the domestic inflation process. The commodity and oil shocks of the 1970s changed that view somewhat. But even today external effects on inflation are often believed to be minor. But there is little justification for the view that the U.S. is very different and that exchange rate movements should not be assigned important effects in the inflation process. Indeed, the large swings in the inflation rate in 1973-74, 1977-78 and 1981-84 were associated with large movements of exchange rates and traded goods prices, relative to the general price level.

The rule of thumb now is that a 10 percent depreciation of the dollar would raise the inflation rate by 1 percentage point. But the effect may well be larger once it is recognized that exchange rate movements work not only via their impact on prices, but in addition via wages. In sectors where a gain in competitiveness improves the employment outlook wage settlements are likely to be generous and hence inflationary. Conversely, under the burden of appreciation, the prospect of job losses dampens wage settlements and can even lead to give-backs. The combined effect of the direct impact of exchange rate changes on prices and the indirect effect via wages may well add up to a much larger impact than the conventional 10:1. Some econometric work shows that a ten percent depreciation may raise inflation by more nearly 2 percentage points.[2] Figure 4 shows an estimate of the impact of exchange rate movements on U.S. inflation.

Three separate price effects of appreciation are worth emphasizing in more detail. First, agricultural prices are closely tied to world markets. An appreciation of the dollar will lower agricultural prices both on the export and import side. The absolute decline in food prices, in an econony where the general price level is still rising, will play an important disinflation role. Second, commodity prices in dollar terms will fall, and that reduces material costs to firms which makes it possible to reduce prices below the rate of increase in unit labor costs. Finally, there may well be an effect on oil prices. The price of oil is largely administered, but there is little question that a boom and a weak dollar, as in 1970-73 or 1977-78 make for increases in real oil prices while a weak world economy and a strong dollar tend to reduce the dollar price of oil. These favorable price shocks associated with a major currency appreciation reinforce the effects of economic slack in promoting disinflation. If the problem is that disinflation must start somewhere, in wages or in prices, then declining import prices provide exactly the room to get disinflation moving.

Whatever the exact linkages between the dollar and domestic inflation, international effects in our inflation process are quite obviously present.

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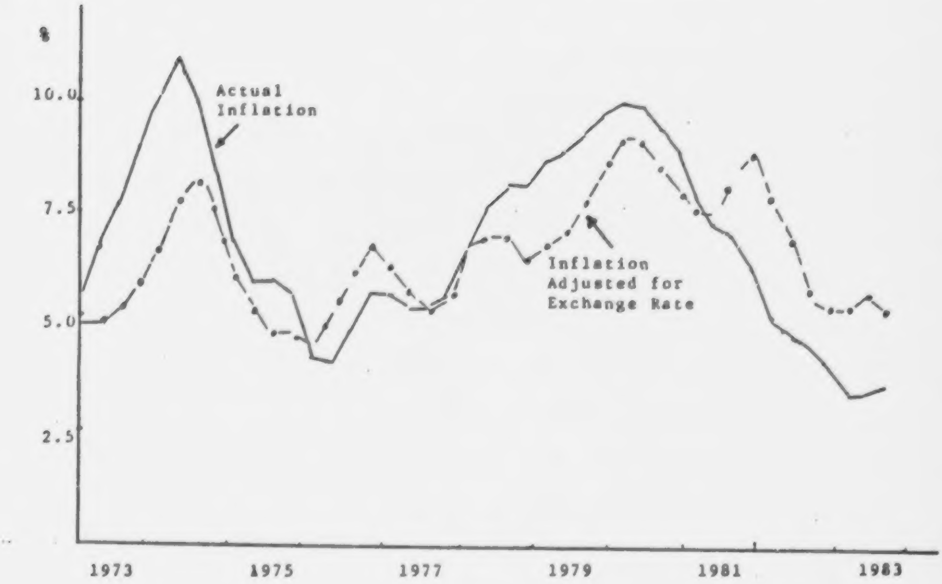
[2] It is difficult to separate the effects of deregulation, changes in labor law, and changes in external competitiveness in the strong decline in the rate of increase of labor compensation. In a paper written with S. Fischer, "The Open Economy: Implications for Monetary and Fiscal Policy," NBER Working Paper No. 1422, August 1984 we find the 10:2 relation.

Figure 4
Exchange Rate Effects on Inflation



Since 1981 the overall GDP deflator has risen by 16 percent, but the deflator for exports increased by only 8 percent while the import price deflator fell by more than 9 percent.

Terms of Trade Gains: In the period 1980-84 the U.S. experienced a gain of about 11 percent in the terms of trade. The prices at which we sold our exports increased relative to those of our imports. The terms of trade gain represents a transfer of real income from the rest of the world to the U.S. economy. The size of the cumulative transfer is close to 1 percent of GNP.

An important part of the terms of trade gain was the decline in real commodity prices, including oil. Empirical evidence suggests that when the dollar appreciates, the real prices of commodities fall in terms of manufactures. This effect has been strongly at work in the past few years. In addition, in manufacturing, export prices kept increasing while import prices fell. As a consequence, our exports acquired increasing purchasing power in terms of imports from other industrialized countries.

The terms of trade gain represents a gain in real income that is available for distribution to restore profitability of firms or raise real wages in a non-inflationary way. Given the relatively large gain in real income from this source it may help explain good macroeconomic performance. Of course, there is a counterpart in countries whose terms of trade have deteriorated.

Competitiveness and Employment: The recovery since late 1982 has produced impressive employment gains, economy-wide and in manufacturing. The same picture emerges for economy-wide employment over a five year horizon, but not so for manufacturing. Table 4 shows these comparisons and draws attention to the medium-term decline in manufacturing.

Table 4 U.S. Employment Growth
(Cumulative Percentage Increase)

	1982-1984:4	1979-1984:4
Total Non-Agricultural Establishments	6.6	6.3
Manufacturing	4.7	-6.4

Source: DRI,Inc.

Table 4 shows a significant difference between economy-wide employment gains and manufacturing. A comparison of current manufacturing employment with the 1979 levels reveals an absolute decline of more than 6 percent. Since 1979 more than 1.3 million manufacturing jobs have been lost. The reduction in employment is not due exclusively to the overvalued dollar and slack demand abroad. Productivity growth, structural change, shifts in demand and the recession all play a role, but foreign influences probably take the front seat.

The loss in manufacturing employment has a counterpart of sharply reduced profitability or outright losses for firms whose concentration of activity is foreign trade related or related to agriculture. The pressure for action on the dollar or protection by business groups and labor leaves no doubt that in manufacturing different segments have shared very unequally in the recovery.

The shape of the recovery clearly has been lopsided, leaving out important segments of manufacturing and agriculture. This poses a serious issue for the future. Firms that now are going out of business won't be there anymore to create output and employment once a more favorable dollar restores their competitiveness. Thus even if a transitorily high dollar is justified by financial considerations, there is a serious issue of survival in industries that are now being taxed by the overvaluation.

4. Foreign Effects of the U.S. Policy Mix.

Our policy mix has affected foreign countries via interest rates, our loss of competitiveness, the decline in world prices brought about by a rising dollar, and finally by our strong growth in spending that has spilled abroad. The inflation effects on other industrialized countries are exactly the counterpart of the gains we have made. Where our inflation is reduced by falling import prices, their inflation is now increased. But there is also a net redistribution from LDCs and oil-producing countries toward industrial countries. The weakening of the dollar price of oil is passed on to all the consuming countries, and all importing countries benefit from the decline in real commodity prices.

Growth: The most obvious influence we have exercised on foreign economies is through the spill-over of our spending growth. Table 5 shows the growth rates of real income and of real spending for 1983-84. The difference represents the external stimulus to growth or the leakage of spending growth into imports. It is apparent that Japan strongly benefitted from the U.S. demand expansion. Europe also shared in our growth, although to a much smaller extent. Comparable data for LDCs are not available. But the pattern is quite clear: their domestic spending was cut absolutely, and the only source of growth has been the increase in net exports.

Table 5 Real Income and Spending Growth
(Cumulative increase 1984 over 1982)

	U.S.	Japan	Europe	Canada
Spending	13.4	5.9	3.0	7.0
GDP	10.4	8.8	3.6	7.6

Source: OECD Economic Outlook.

We saw earlier the sharp deterioration in the U.S. external balance. Table 5 brings out how that worsening of our net exports translates into U.S. support of growth abroad.

Effects on Debtor-LDCs: The cure of the debt crisis, as seen by optimists, was above all a strong world economy; in particular a path of 3 percent growth per year, for a couple of years, was seen as the key ingredient in providing debtor-LDCs with a favorable setting to export themselves into solvency. The sustained growth of the industrial countries would provide the markets for LDCs exports, and also bring about a cyclical recovery of the deeply depressed real commodity prices thus enhancing export earnings. In addition interest rates were expected to decline significantly from their 10 percent levels of early 1983. A large decline of the dollar was expected to reinforce the ease of adjustment.[3]

The growth certainly has materialized, since in 1983-84 the world-wide recovery proceeded at a rate in excess of 3.5 percent. Being led by the U.S. economy with its relatively open market, there was a ready opportunity for the debtor countries to find export revenue. But while the growth of industrial countries supported the optimistic scenarios, the further appreciation of the dollar, and the rise in dollar interest rates in early 1984 did not help. Even so the debtors emerged from the 1983-84 adjustment period with strong external balance performance. There is now almost a consensus that the worst part of the debt crisis is already gone, at least in what concerns the external financial aspects.

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[3] See especially the analysis by William Cline, International Debt and the Stability of the World Economy, MIT Press and Institute for International Economics, September 1983.

The pattern of adjustment differed from one debtor to another. It is nevertheless instructive to see a particular example: the case of Brazil. Table 6 shows Brazil's external accounts for the period 1982-84.

Table 6 Brazil's External Adjustment
(Billion $ U.S.)

	1982	1983	1984
Non-Interest Surplus	-3.7	3.3	11.2
Exports of Goods	20.2	21.9	27.0
Imports of Goods	19.4	15.4	13.1
Non-Interest Services	4.5	3.2	2.7
Interest Payments	12.6	10.3	10.6

Source: Conjuntura and Banco do Brasil.

It is worth dwelling in some detail, though, on how the adjustment was achieved despite a higher dollar and higher interest rates. One view is that export earnings were so sharply increased, as a result of U.S. growth, that the earnings increases more than paid for the extra interest, leaving the debtor countries in a net improved position. But in fact the debtor countries had to increase their exports substantially without the benefit of lower interest rates or significant terms of trade gains. On balance the cyclical improvement of LDCs' terms of trade was minor or simply did not occur. The inflationary erosion of debts resulting from a collapse of the dollar did not occur either. The adjustment on the external side thus was brought about entirely by trade performance rather than terms of trade on capital gains.

There was, of course, also a steep fall in per capita real incomes. Even optimists doubt that Latin America will return to the 1980 real income levels before the end of the decade.

The extent of the recession in Latin America can be judged from the following data: in the period 1967 to 1980, Latin America enjoyed per capita growth at an average annual rate in excess of 3.5 percent. In 1981-84 the rate was -3 percent. The much heralded recovery of 1984 was a growth rate of per capita income of barely 0.2 percent. The domestic set-back in the debtor countries thus will remain a serious issue for many years to come.

5. The Need to Cut the Budget.

There are two good reasons to start making inroads on the deficit immediately. The first concerns trade-offs between deficits today and surpluses tomorrow. Given that the real interest rate is positive and exceeds the trend growth rate of output, the government must be concerned with the budget constraint. A policy of accumulating debt and financing the interest by yet further interest makes debt grow relative to income, thus building up an ever increasing future budget problem. The longer the adjustment is delayed, the larger must be future non-interest surpluses to service the debt accumulation that arises from the deficits today.

The trade-off between rapid and slow adjustment can be illustrated with a simple calculation involving the government budget constraint. Suppose that trend growth of output is 3 percent, the real interest rate is 5 percent, the initial ratio of debt to income equals .5. Let there be an initial and transitory component of the deficit that is 3 percent of income and is eliminated over time. In the first case, the transitory deficit is reduced by 20 percent every year. In this case, the longrun non-interest surplus consistent with the government budget constraint is 1.8 percent of GNP. If instead 95 percent of the deficit reduction took place every period, the longrun non-interest surplus would only need to be 1 percent of GNP.

Slow adjustment of deficits, or the persistence of deficits, thus has large longrun consequences. The only way one can belittle these longrun effects is to believe that in the future, trend growth will rise and real interest rates will come down. That may well be the case, but there is certainly no compelling reason for this to happen.

The second reason to reduce deficits is that the structure of the economy is adversely affected. High real interest rates, in part due to the deficits, and the lack of external competitiveness impair the investment and therefore the trend growth of output. They therefore aggravate the intertemporal trade-offs over and above what was already argued.

The budget deficits lead to exchange rate overvaluation and hence a loss of competitiveness and profitability in the traded goods sector, that is in manufacturing and agriculture. In the shortrun overvaluation simply implies losses that can be weathered. But if overvaluation persists then ultimately firms will close and jobs will be lost. Once the overvaluation is undone, firms and jobs will already have disappeared, it will take time and extra profitiability (over depreciation) to bring them back into existence.

Failure to cut the deficits now, thus involves actual disinvestment and destruction of capital in a wide sector of the economy.

The need to correct deficits is all the more compelling because the worst part of the recession is gone, so that there are no strong cyclical reasons for deficits as far as the eye can see. Moreover, the difficulty of restoring fiscal discipline is easily exaggerated. The U.S. is assuredly not suffering from overtaxation, and hence budget balancing by increased personal taxation is entirely plausible.

The correction of the deficit need not take place at the expense of growth. A tightening of fiscal policy provides room for a more expansionary monetary policy which, via reduced real interest rates, promotes increased capital formation. Capital formation in turn provides the jobs and productivity gains that afford strong, non-inflationary trend growth. Because monetary ease can make up for the aggregate demand effect of fiscal tightening, there is no reason to expect a significant slowdown of the economy. On the contrary the shift in the monetary-fiscal mix enhances the chances of actually getting to high employment.

A shift in the monetary-fiscal mix will in all likelihood bring the dollar down. Thus among the sources of growth there will also be an improvement in our net exports. But that presupposes that the rest of the world is willing to tolerate a deterioration of their performance. That is possible in Europe to the extent that lower world interest rates will improve budget deficits and therefore free budgetary resources for tax cuts. In any event Europe cannot help but offset the reduced demand by a sorely needed fiscal easing. Likewise, in debtor LDCs lower interest rates and dollar devaluation will provide more room in foreign exchange budgets.

Of course, the fiscal correction is not an unmixed blessing. Dollar devaluation will certainly increase inflationary pressure. But if the depreciation were limited to say 15%, then disinflationary effects of soft wage settlements and declining oil prices might to some extent offset the impact on our inflation. In any event the problem of coping with the inflationary impact of unhooking the dollar is unavoidable some time. We might as well do it while inflation is low and labor is weak. Early adjustment is all the more reasonable since the problems grow as we delay action.

6. Other Remedies for External Competitiveness.

Supposing that swift and substantial budget action is unlikely, what can be done about the lack of competitiveness? There are broadly three options: intervention in foreign exchange markets, a tariff, and transitory taxes on international capital flows.

A large body of literature has established that intervention, in the absence of a fundamental policy change, has no lasting effect on the exchange rate. Indeed on the scale on which intervention typically takes place, it may have no effect whatsoever. As a policy to restore U.S. competitiveness it would be ineffective. But suppose for a moment that it actually worked. In that case U.S. growth would be pushed up by an improving external balance on top of fiscal stimulus. The high growth and the inflationary impact of depreciation would presumably force the Fed to tighten money, thus undoing the depreciation or worsening investment performance. The point is that we should not look at a desirable level of the dollar independently of macroeconomic fundamentals.

An unfortunate idea that has made its appearance recently is the notion of a uniform import surcharge for "balance of payments reasons". The surcharge is sold as a move in support of increased competitiveness with the side benefit of enhancing budget revenues. While the macroeconomics of the proposal--expenditure reduction combined with expenditure switching toward domestic goods is right--the microeconomics is terrible. The last ten years have already seen an ever increasing level of protectionism and cartelization in world trade. A further move by the U.S. in this direction would likely provoke a 1930s style retaliation with adverse effects on our exports, world trade and international payments. Certainly debtor countries would find it even harder to pay their interest bill and might, just as in the 1930s, be led to default. A uniform import surcharge is simply a bad dream.

Capital controls are the respectable form of intervening in a market that is judged to be out of tune with fundamentals. If investors believe there are unusually high returns on U.S. securities relative to those abroad, they will of course seek to buy U.S. assets and thus drive up the dollar. The effective means to change their minds is to introduce a (transitory) withholding tax that reduces the non-resident return on domestic securities. With reduced returns, capital inflows will slow down, or capital will actually seek to leave. The current account deficit could no longer be financed at the going exchange rate and hence the dollar would immediately decline.

Once again we would face the problem that expansionary fiscal policy and a sharp improvement in the external balance together with a depreciating dollar, near full employment, might just turn out to be a highly unstable situation. The upshot of the argument is that external competitiveness and the current account deficit cannot be decoupled from the fundamental priority of correcting the budget deficit.

Chairman **Domenici**. Dr. Nordhaus, good to see you again.

Dr. **Nordhaus**. Nice to see you, Senator.

I would like to submit my testimony for the record and take ten minutes or so to summarize the major points.

Chairman **Domenici**. It will be made a part of the record.[1]

STATEMENT OF DR. WILLIAM NORDHAUS, JOHN MUSSER PROFESSOR OF ECONOMICS, YALE UNIVERSITY

Dr. **Nordhaus**. It is clear that this country and this Committee faces some wrenching decisions ahead of it, and what I would like to do is to lay out for you what I see as some key economic aspects of that question.

First, let me start with the issue of assumptions that you should use in your forward planning. It is clear that over the past the CBO has a better track record than any recent administration in forecasting deficits. So it seems to me that the baseline estimates of the CBO, with the fiscal year 1988 total deficits of about $250 billion, form the appropriate point of departure for your exercises.

I suspect that this baseline estimate may be a bit optimistic. It does not allow for a recession in the next few years, which seems to me very likely from the lessons of history; it omits any new programs; it also omits the possibility that the dollar may fall, leading to higher interest rates. I could envisage deficits of, say, $30 to $60 billion higher than the baseline by the end of the 1980's.

Let me turn to the major part of my testimony, which is the consequence of high deficits and high debt. What are the costs of high deficits? First, let me begin by reviewing what seem to be some misleading answers, ones that modern mainstream economists would probably reject.

Senator **Chiles**. Is that mike on, Dr. Nordhaus? I am having a little trouble hearing you.

Dr. **Nordhaus**. Is this better?

Senator **Chiles**. Yes.

RELATIONSHIP BETWEEN DEFICIT RECOVERY PROGRAMS AND ECONOMIC RECOVERY

Dr. **Nordhaus**. Let me start by discussing some misleading questions. One important one concerns the issue of the relationship between deficit recovery programs and economic recovery.

In today's climate, with the economic management we have, I would recommend that you not factor the impact of deficits on recovery in making your budget plans. Let me explain why.

I think many noneconomists have been confused in this area over the last few years because they have been the target of scaremongering sermons from many points of view. You were told a couple of years ago how high deficits would abort the recovery or raise unemployment. It does not take very good vision to see that such forecasts were not accurate. Moreoever, such predictions were never based in sound economic analysis.

In today's climate, you might have similar concerns. But I would suggest that the Federal Reserve is likely to take the necessary steps to offset any impact on employment and output of a long-term deficit recovery program. It is clear that the Federal Reserve can—and as I read Chairman Volcker's statement yesterday, they will—take the necessary steps to assure that the economy is operating in its target unemployment, output and inflation range.

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[1] See p. 321.

So if the structural deficit is cut, I see no obstacles that would prevent the Federal Reserve from neutralizing the economic impact of those cuts with the appropriate degree of monetary stimulus. It would be appropriate, perhaps, for the Congress, which directs the Federal Reserve, to make than an explicit part of any deficit reduction package.

STATEMENTS ABOUT HARMFUL EFFECTS OF DEFENSE CUTS ARE APPALLING

In this regard, let me say that I am dismayed and appalled by recent statements of Secretary Weinberger about the harmful effects of defense cuts. Such analysis, if written by college freshmen at Yale or the University of New Mexico, would earn an "F" in economics, for two reasons.

First, it would earn an "F" because it ignores the impact of the Federal Reserve in its conduct of monetary policy. But, more important, there seems to be a presumption in the statement that defense cuts contract the economy more than do nondefense cuts in goods and services. But that really flies in the face of both economic evidence and common sense. How can the cancellation of $100 million of tank purchases be more contractionary than cancellation of $100 million of truck purchases? Or, who could seriously believe that trimming military pensions would induce a recession, while cutting civilian pensions would not?

There need be no apologies for a sound defense program, but to buttress the defense of defense with such palpably false arguments is distressing, because it is both bad economics and additionally it destroys the credibility of good public policy analysis.

Well, what, then, are the true economic impacts of government deficits and debts? This is one of the most complicated and complex questions of modern economics, and I would like to emphasize that the answers are only incompletely known.

Chairman DOMENICI. They are what?

Dr. NORDHAUS. In part, the answers are complicated because emotional factors weigh heavily—deeply held beliefs about budget balance, fiscal discipline, or the appropriate size of the government. Moreoever, we are headed into uncharted territory. We have never in our history had such an increase in public debt in peacetime.

But economic analysis can point to two aspects of concern. First, is what I would call the capital-displacement effect, whereby government debt displaces some productive physical capital, thereby reducing future output and consumption; second, and most alarming, the current debt trajectory is on an explosive path, somewhat like a runaway nuclear reaction.

Let me explore each of these briefly.

IMPACT OF CAPITAL DISPLACEMENT EFFECT IS RELATIVELY STRAIGHTFORWARD

Starting with the capital displacement effect, the impact is relatively straightforward. If the Government decides to borrow $1 billion rather than raising taxes or cutting spending, there is $1 billion more that must be held in people's portfolios. Hence, the public will hold somewhat less in stocks and bonds and savings accounts that could be otherwise used to finance tangible capital in trucks or computers or factories, or to invest in foreign investment. And the smaller capital stock will produce less output and less consumption for the Nation.

If you take the 4 years ending in September 1985, we find an increase in the Government debt of around $600 billion in 1985 prices. The $600 billion question is, how much capital is in fact displaced by this $600 billion increase in the Government debt.

Now, I wish I could be a one-handed economist and give you a figure with the confidence that a physicist can tell you the speed of light. But, alas, our profession is divided. We have no experiments that we can draw upon to give you an exactly calibrated number.

If I might, I will give you two historical episodes that illustrate why we do not know the precise answer.

The Pollyannas point to the postwar era in America. At the end of World War II, the U. S. Government debt had risen to 111 percent of GNP, almost three times what it is today. Yet there soon followed one of the most robust growth periods of American history. And indeed, as the Government debt shrank relative to the size of the economy by the 1970's, our economy seemed to lose its vigor.

Or, if you were sitting in the Chamber with Prime Minister Thatcher yesterday, you might have asked her what was Britain's debt position during the Pax Britannica after the Congress of Vienna. Britain's internal debt reached an astronomical figure of 210 percent of its GNP in the early 19th century. Yet this heralded in the century of Britain's greatest economic, military and political power. Thus speak the Pollyannas, who would have us not worry about debt.

HOUSEHOLD SAVINGS RESPOND NEGLIGIBLY TO HIGHER INTEREST RATES

The Cassandras, on the other hand, will point to the fact that household savings respond negligibly to higher interest rates. For example, wouldn't you think that the higher interest rates since 1979, along with the generous saving incentives you enacted in 1981, would lead households to save more these days? In fact, if you look at household saving since 1981, you will find it has actually declined relative to the prior decade. Moreover, study upon study has shown how little saving responds to higher interest rates.

Armed with such facts, you might throw up your hands and ask what are nonspecialists to conclude from the contradictory evidence. And I would say there are two things.

First, if anyone claims to have discovered the revealed truth about the precise impact of the debt on our capital and consumption, do not believe it. The economic jury is still out on the precise amount of capital displaced by Government debt.

However, such agnosticism provides little comfort to a Senator, who must put his or her seat on the line in a vote on the budget. Faced with such a decision, in your seats so to speak, I would lean toward the pessimists who fear substantial capital displacement. Such a posture is appropriate in part because the evidence on the insensitivity of savings to interest rates looks so persuasive.

But more important, it seems to me that in a situation where the evidence is mixed, prudent and responsible public policy must allow for the possibility that capital displacement might be sizable.

We are not sure if the amount of capital displaced over the next 4 years will be $100 billion or $400 billion or $600 billion, but giver the possibility that the number may be large, and given that the consequences may be so unpleasant, that there is no option for responsible public policymakers but to take sharp and swift action to curb the deficit.

I will just pass over the issue of the runaway debt, which is a substantial question and one that is alarm up. Merely note that, even though our debt is growing at a very rapid rate and much more rapidly than our economy, we are still many decades away from the point where the debt explosion gets completely out of control. The problems of Argentina and Brazil and Bolivia are not just around the corner.

HOW FAR SHOULD THE DEFICIT BE REDUCED AND HOW FAST

Now, in light of the consequences of deficits, the question you might ask is, how far should the deficit be reduced and how fast?

A draconian target might aim for a debt/GNP ratio at about today's level of 40 percent. This would reduce deficits by about $300 billion over the next years relative to the CBO baseline. That is a relatively draconian budget with cuts of $80 billion in fiscal year 1986, $100 billion of cuts in fiscal year 1987, and $120 billion of cuts in fiscal year 1988. Such step are needed to stabilize the debt/GNP ratio at todays' level.

Now, Congress might be willing to accept a higher steady debt/GNP ratio—say, 50 or 60 or 70 percent—with the conseqment higher amount of capital displaced. In such a case, it could push for less rigorous deficit reduction trajectories. The administration, notwithstanding its pious rhetoric, has a very weak commitment to deficit reduction. Indeed, I would call theirs the Alfred E. Newman approach to deficit reduction, that is, "What, me worry?"

The Alfred E. Newman philosophy involves deficits at 5 percent of GNP as far as the eye can see, and it is easy to calculate that, at current long-term growth rates of GNP, the Newman approach would lead to a debt/GNP ratio of about 70 percent, fully 30 percentage points higher than today's level.

Now, the administration's fiscal policy may lend the graveyard humor of MAD magazine to our present dilemma, but when the laughs have died, it seems to me fundamentally irresponsible. It allows our valuable capital stock, won by the sweat of generations, to be dissipated in a few years of fiscal debauchery.

A goal for deficit reduction is easy to state, but hard to achieve, and there are no scientific answers to the best approach. Those choices must reflect political judgments, for which people like yourselves are best equipped to make. I would like to emphasize that neither tax increases nor spending reductions have scientific claim, to superiority. A person who says that spending reductions are economically more effective or efficient is either deceiving himself or trying to deceive you.

However, I would suggest two general principles to weigh in making your decision.

CUTS ARE PENNY-WISE AND DOLLAR-FOOLISH

First, we should not burn the barn to roast a pig. As has been emphasized by this panel the purpose of deficit reduction is to prevent an erosion of our productive capital. It therefore makes no sense to cut public investment as a way of encouraging fractionally private investment. So think twice before curbing those programs that contribute to the human or tangible capital of the Nation.

To be precise, some of the dubious programs in the administration budget that would cut public investment are the following: halting investment in oil for the strategic petroleum reserve; trimming civilian science, research and development; reducing health or education programs that promote a healthier, better trained and more productive labor force; cutbacks in child nutrition programs. These cuts are penny-wise and dollar-foolish. They cut back on demonstratedly effective public investment programs to promote a fractional increase in private investment.

I might say that similar principles apply to the design of a tax system. The Treasury is quite clear on that principle and, I think, deserves to be listened to.

TRADEOFF BETWEEN DEFICIT REDUCTION AND EFFICIENCY

A second general point concerns the tradeoff between deficit reduction and efficiency. Congress is naturally concerned that many deficit reduction measures would hamper productivity and efficiency. For example, certain kinds of tax increases might hurt the efficiency of the capital stock or might harm the incentives for labor supply. However, there are some measures that would actually increase the efficiency of resource allocation while reducing budget deficits. They are not painless, and they may have strong constituencies, but from an economic point of view, they increase efficiency.

Looking to the spending side, I am puzzled that the administration's budget continues to allow some dubious subsidy schemes such as maritime subsidies and milk price supports. Moreoever, I think that there is a good case in some people's minds to——

Chairman **Domenici**. Did you say milk price supports?

Dr. **Nordhaus**. Yes, sir.

Senator **Kasten**. Is that what he said?

Chairman **Domenici**. I think they recommend its elimination.

Dr. **Nordhaus**. I am sorry. I missed that.

Chairman **Domenici**. The Senator is not sure of that, but the President is.

Dr. **Nordhaus**. OK. Then, scratch that, and let me just include maritime subsidies, which is going to be growing in the future.

Trimming excessively generous income support programs also seems to have a case based on economic efficiency. And finally, one of my major concerns is defense programs that bid resources away from key civilian activities. The enormous growth in military R&D spending is clearly crowding out civilian research and development, which is a key to long-term economic growth.

On the revenue side, numerous proposals in the Treasury tax reform would enhance economic efficiency, but I think even more impressive would be energy taxes, particularly ones on oil and natural gas consumption. These taxes would raise revenues while enhancing our national security, by further lowering our dependence on foreign energy.

I would also suggest, although it is outside the purview of this committee, a wide variety of user fees and environmental taxes, such as waste end taxes to support Superfund, or taxes on sulfur emissions, as a means of curbing acid rain. These are taxes which both raise revenues and help economic efficiency.

MAINTAIN A SENSE OF PERSPECTIVE

In conclusion, it seems to me that the most difficult thing in this year of debate is to maintain a sense of perspective. Curbing deficits is indeed the top economic priority, and is likely to remain so for many years. But I think we must be suspicious both of those who downplay the importance of deficits, along with those who prophesy a fiscal apocalypse. Be skeptical of those who advocate a scorched-Earth policy, destroying the public sector in order to build a barn for sacred Pentagon or private-sector cows. Reject as well the Alfred E. Newman or "What, me worry?" approach to deficits as economically irresponsible. Above all, it is a false economy to trim deficits by leaving our children so hungry that they cannot study, our bright but poor minds uneducated, our oil reserve half-filled, our roads and bridges crumbling, and our civilian research laboratories decimated.

We should not destroy the economy in order to save it.

Thank you very much, Mr. Chairman.

Chairman DOMENICI. Thank you, Dr. Nordhaus.

[The prepared statement of Dr. Nordhaus follows:]

CURBING THE DEFICIT WHILE MEETING NATIONAL PRIORITIES

Testimony of William Nordhaus
Professor of Economics, Yale University

Before the Senate Budget Committee
Febrary 21, 1985

The United States today faces a wrenching series of decisions on how to reduce Federal budget deficits. I would like to discuss with you key economic aspects of that question:

o What are the economic costs to the nation of the rapid growth in government debt?

o How fast and how far should the deficit be trimmed?

o What are the most productive, what the most counterproductive, ways to curb the deficit?

Background Assumptions

To begin, let me state what seems to me the most plausible baseline scenario from which deficit reduction begins. Historically, the CBO has a better track record in predicting outyear budgets than does any recent Administration. Therefore the baseline estimates of the CBO, with a FY 1988 total deficit of $250 billion, form the point of departure. This figure may actually be somewhat optimistic, for it does not allow a recession (which is likely to occur over the next three years); and it omits any new programs (such as those called for by a disastrously good harvest or volcanic eruption), which seem mainly to produce higher deficits.

The economic assumptions are also on the optimistic side. Many economists suspect that the dollar may depreciate sharply over the coming years -- producing higher inflation, higher interest rates as the Federal Reserve acts to contain excessive economic growth, and a concomitant rise in interest payments on the government debt.

Adding these three potential surprises together, I could envisage deficits $30 to $60 billion higher than the CBO baseline in the late 1980s.

Consequences of High Deficits

Misleading analysis. What are the costs of high deficits? First, let me begin by reviewing misleading answers -- those held incorrect by modern mainstream economics.

One confusing question, nagging at deficit-reduction programs, concerns their potential impact on economic recovery. In today's climate, I would recommend that cyclical concerns or potential recessionary effects not be a factor in choosing deficit cuts.

Many non-economists are confused in this area because they have been the target of scaremongering sermons over the last few years -- being told, for example, how high deficits would abort the recovery or raise unemployment. Such theories were never based in sound economic analysis or experience.

In today's climate, it seems likely that the Federal Reserve would take steps to offset the impact on unemployment and output of any fiscal program that the Congress will fashion. Over the multi-year period of these programs, the Federal Reserve can -- and, judging by recent actions, will -- take the necessary steps to assure that the economy is operating in the range of unemployment and inflation rates that it is pursuing. If the structural deficit is sharply cut, I see no obstacles that would prevent the Federal Reserve from neutralizing the fiscal contraction with the appropriate degree of monetary stimulus.

In this regard, I am dismayed and appalled by recent statements of Secretary Weinberger about the harmful economic effects of defense cuts. Such analysis, if written by a college freshman in a course in macroeconomics, would earn an "F" for no less than two reasons. First, as noted above, during the period over which the fiscal impacts occur, defense cuts are likely to be offset by monetary expansion -- thereby offsetting their contractionary impacts.

More important, the presumption that, in the absence of monetary policy offsets, defense cuts contract the economy more than do non-defense cuts in spending on goods and services ignores both economic evidence and common sense. How can cancellation of $100 million of tank purchases be more contractionary than cancellation of $100 million of truck purchases? Who can seriously believe that trimming military pensions would induce a recession while cutting civilian pensions would not?

No apologies need be given for a sound defense program. But to buttress the defense of defense with such palpably false arguments is doubly distressing both because it is bad economics and more generally because it destroys the credibility of defense and public policy analysis.

Modern views. What are the true economic impacts of government deficits and debts? This is one of the most difficult questions of modern economics, one to which the answers are complex and incompletely known. In part, the answers are complicated because emotional factors weigh heavily -- deeply held beliefs about budget balance, fiscal discipline, or a potential fiscal doomsday looming ahead of us. Moreover, the American economy is heading into uncharted fiscal waters, so the economic reactions cannot be read in any history book.

But economic analysis points to two aspects of concern in today's soaring debt. First, the growing government debt may displace some productive physical capital, thereby reducing future output and consumption. Second, the current debt trajectory is currently on an explosive path, like a runaway nuclear reaction.

Capital displacement. Let's explore the capital-displacement effect first. Say that the government decides to borrow $1 billion rather than raise taxes or cut government spending. As a result, the public must hold $1 billion more of government debt in its portfolio. Hence, the public will hold somewhat less in stocks, bonds, and savings accounts that could otherwise be used to finance tangible private domestic capital or foreign investment. A smaller capital stock will produce less output and less consumption for the nation.

Over the four years ending in September 1985, the total public Federal debt of the United States held by the public (including the

Federal Reserve) will rise about $720 billion. Correcting for inflation, the increase in government debt (in 1985 prices) will be around $600 billion.

How much domestic capital and net foreign investment will eventually be displaced by this increment of $600 billion in government debt? To answer this question requires understanding the capital-displacement mechanism. In the first instance, real interest rates will have to rise to induce the public to hold the higher debt. There is, however, a savings reaction of households, firms, state and local governments, and foreigners -- these groups may save more as a result of the higher interest rates. The extent to which the $600 billion in higher debt displaces capital depends upon the size of the savings reaction. If savings respond negligibly to changing interest rates, we may find almost $600 billion of capital displaced; if savings rise powerfully as interest rates rise, or if people save in anticipation of higher future taxes, then little displacement of capital may occur.

The $600 billion question is clearly, how much capital in fact will be displaced? I wish I could be a one-handed economist and provide you a figure with the confidence that physicists can tell you the speed of light. Alas, the economics profession is divided, and no controlled experiments allow precise calibration of the amount of capital displaced. Two historical episodes may illustrate why economists are so divided:

o Pollyannas point to the postwar era in America. During World War II, government debt rose to 111 percent of GNP. Yet there soon followed one of the most robust growth periods of American history. Indeed, as the government debt shrank relative to the economy in the 1970s, our economy seemed to lose its vigor.

What, you might further ask, was Britain's debt position during the Pax Britannica after the Congress of Vienna? Britain's internal debt reached a high of 210 percent of its GNP in the early nineteenth century -- heralding in the century of Britain's greatest economic, military, and political power.

o Cassandras will point to the fact that household savings respond negligibly to higher interest rates. For example, wouldn't you think that the higher real interest rates since 1979 along with the generous savings incentives enacted in 1981 would lead households to save more these days? In fact, household saving has actually dropped since 1981, averaging 5.8 percent of income during the 1982-84 period as compared to 7.0 percent of income in the prior decade. Study upon study has shown how little saving responds to higher interest rates.

What are non-specialists to conclude from the contradictory evidence? To begin with, if anyone claims to have discovered the revealed truth, don't believe it -- the economic jury is still out on the precise amount of capital displaced by government debt.

However, such agnosticism provides little comfort to a Senator who must put his or her seat on the line in a vote on the budget. Faced with such a decision, in your seats so to speak, I would lean toward the pessimists who fear substantial capital displacement. Such a posture is appropriate in part because the evidence on the insensitivity of saving to higher interest rates looks so persuasive.

Moreover, in a situation where the evidence is mixed, prudent and responsible public policy must allow for the possibility that capital displacement might be sizable. We are not certain if the amount of capital displaced by the deficits of the next four years will be $100 billion, $300 billion, or $600 billion. But the possibility that the number may be large, and the unpleasant consequences of such large losses in our capital stock and living standards, leaves no option for responsible public policymakers but to take sharp and swift actions to curb the deficit.

An analogy might make the point more clearly. What should we do in a situation where intelligence information provides conflicting signals as to whether a powerful country is hostile or neutral? Clearly, it would be imprudent to assume a potential adversary is friendly and to disarm.

The runaway debt. The second aspect of the current deficit, and one that is even more alarming than the first, concerns the possibiity of a runaway government debt. The government debt peaked at 111 percent of GNP in 1945, then fell continuously over the next three decades, reaching a low of 25 percent in 1974. As deficits soared beginning in 1981, the debt began to climb rapidly relative to GNP, and is expected to reach 39 percent at the end of this fiscal year.

We are witnessing a runaway government debt, a debt that over the last four years has grown 91 percent while GNP has grown only 34 percent. Such unchecked growth is truly frightening. In the short run, a growing debt-GNP ratio leads to higher debt service and higher tax rates simply to pay the growing interest charges. The resulting fiscal stimulus will lead to monetary contraction, raising interest rates and further worsening the debt explosion.

In the long run, a runaway debt presents the prospect of a loss of confidence in the full faith and credit of the Federal government, along with massive displacement of capital as the private saving increasingly goes to support public dissaving. Given the inherent instability of financial markets when confidence is lost -- an instability most recently seen in the crisis surrounding the collapse of the Illinois Continental Bank last summer -- how such a scenario would evolve defies prediction.

The country is still many years from the point when the exploding debt will lead to a fiscal meltdown. It would take decades of high deficits for the debt explosion to get completely out of control. But the possibility of a runaway debt swallowing a substantial portion of the accumulated savings of Americans gives further urgency to the need for deficit reduction.

How Far and How Fast a Deficit Reduction?

In light of the consequences of deficits, how far should the deficit be reduced? Given the prospect of a runaway debt, a minimal deficit reduction program would aim to stop the rise in the debt-GNP ratio. A draconian target might aim for a debt-GNP ratio no higher than today's level, a debt-GNP ratio of 40 percent. With nominal GNP rising at 7 to 8 percent over the next few years, this suggests a target for cumulative deficits over the next three years of $400 billion. This target compares with about $700 billion in deficits in the next three years under the most recent CBO current services budget.

To reduce deficits so that the amount of government debt stabilizes at 40 percent of GNP could be implemented with deficit reductions of $80 billion in FY 1986, $100 in FY 1987, and $120 billion in FY 1988. Put differently, in order to stabilize the debt-GNP ratio at its current level, the deficit must be reduced to around $130 billion by FY 1988.

If Congress wishes to accept a higher steady debt-GNP ratio, say 50 or 60 or 70 percent, with the accompanying higher amount of capital displaced, then it could push for a less rigorous deficit-reduction trajectory. The Administration -- nonwithstanding its pious rhetoric and fundamentalist fiscal proposal for a budgetary Prohibition in the form of a constitutional amendment to balance the budget -- has only a weak commitment to deficit reduction. Indeed, theirs is the Alfred E. Newman approach to deficits: "What, me worry?" The Alfred E. Newman philosophy involves deficits at 5 percent of GNP as far as the eye can see. It is easy to calculate that, at current projections of the growth of nominal GNP, the Newman approach will lead us to a debt-GNP ratio of around 70 percent.

The Administration's fiscal policy may lend the graveyard humor of MAD magazine to our present dilemma. But when the laughs have died, it is fundamentally irresponsible -- allowing our valuable capital stock, won by the sweat of generations, to be dissipated in a few years of fiscal debauchery.

What Road to Deficit Reduction?

A goal for deficit reduction is, alas, easy to state but hard to achieve. Moreover, there are no scientific answers as to the "best" way to reduce deficits -- rather, the choices must reflect political value judgments among competing national priorities. Neither tax increases nor spending reductions have any scientific claim to superiority. A person who says that spending reductions are economically more effective than tax increases is either deceiving himself or trying to deceive you.

Nonetheless, I would like to suggest some general principles to weigh in making your decisions. First, we should not burn the barn to roast a pig. The purpose of deficit reduction is to prevent an erosion of our productive capital; it therefore makes no sense to cut $100 of productive public investment to encourage $20 or $50 or $80 of private investment. For this reason, think twice before curbing those programs that contribute to the human or tangible capital of the nation.

Examples of such dubious proposals are halting investment in oil for the Strategic Petroleum Reserve; trimming civilian science, research, and development; reducing health or education programs that promote a healthier, better trained, and more productive labor force; and cutbacks in child nutrition programs. Reductions in these areas are penny wise and dollar foolish -- cutting back on demonstratedly effective public investment programs to promote a fractional increase in private investment.

Similar principles apply to design of a more efficient tax system.

The Treasury tax reform proposal is a menu with many worthwhile suggestions. Some of them -- for example, removing the deductibiity of employee fringe benefits on items like health care or state and local taxes or consumer interest payments -- would clearly promote a more effective resource allocation.

However, the proposal to repeal the investment tax credit (ITC) and to reduce the value of depreciation allowances (the ACRS system) presents a more problematic solution to deficit reduction. It is a good bet that a repeal of the ITC or ACRS would lower the deficit but would also end up decreasing total investment in plant and equipment.

A second general point concerns the tradeoff between deficit reduction and efficiency. Congress is naturally concerned that many deficit-reduction measures would hamper productivity and efficiency. However, some measures would actually increase the efficiency of resource allocation while reducing budget deficits.

Examples on the spending side would include removing some dubious subsidy schemes (such as maritime subsidies or milk-price supports); trimming excessively generous income-support programs (which in some minds include social security and medicaid); cutting back on defense programs that bid resources away from key civilian activities (the enormous growth in military R & D spending, crowding out civilian research, is particularly worrisome in this respect).

On the revenue side, numerous provisions in the Treasury tax reform proposal would probably enhance economic efficiency. Even more impressive would be energy taxes, particularly ones on oil and natural gas consumption. These taxes would raise revenues while enhancing our national security by lowering further our dependence on foreign energy sources. The Congress might also consider imposing a wide variety of user and environmental taxes. Worthy entries are waste-end taxes to support Superfund along with taxes on sulfur emissions as a means of curbing acid rain.

Conclusion

Perhaps most difficult to maintain in the debate over the deficit is a sense of perspective. Curbing deficits is the top economic priority for this year, and is likely to remain so for the term of this President. We must be suspicious of those who downplay the importance of deficits along with those who prophesy a fiscal apocalypse. Be skeptical of those who advocate a scorched-earth policy, destroying the public sector in order to build a barn for sacred Pentagon or private-sector cows. Reject as well the Alfred E. Newman ("What, me worry?") approach to deficits as economically irresponsible. Above all, remember that it is a false economy to trim deficits by leaving our children so hungry that they cannot study, our bright but poor minds uneducated, our oil reserve half-filled, our roads and bridges crumbling, and our civilian research laboratories decimated. Do not destroy the economy in order to save it.

NUTRITION PROGRAM HAS BEEN VERY EFFECTIVE

Chairman **Domenici**. Let me just ask you one question about your statement on nutrition. I do not know that you have had a chance to look at the actual reform proposals. But might I ask you if it would still be in your category of things you should not do, if most of the nutrition reductions were in the 20 cents subsidy on school lunch for families at 185 percent of poverty. If it was in WIC or some of the others, I think it fits what you have described, but I do not know if that does.

What we have are three levels of subsidy for lunches. One level is for those whom we have deemed historically could not afford it. Then, we have added 85 percent to the proverty level. And then, even when we are there, we subsidize 20 cents. This is where a huge amount of this nutrition reduction occur.

Now, does that fit the list?

Dr. **Nordhaus**. I would make two general answers to that question. First, there is a recent book by Sol Levitan on many public policy programs, and he cites a number of studies on child nutrition. That apparently has been one of the most effective public policy programs in terms of actually lowering malnutrition in children.

We do have many silly programs; I do not dispute that. But this is one program which has been very effective.

If we had a pediatrician on the panel, I think a pediatrician would tell you how important child nutrition is for growth and education.

Chairman **Domenici**. Oh, I understand. But one would have to assume that the lunch program we have would not work.

Dr. **Nordhaus**. Yes. The second point is, I think in such a program, it is impossible to target it completely and efficiently on a certain group of children. No doubt, there is going to be some spillover to families, or to children of families, that do not in any sense deserve the subsidy. And the question is whether that is the minimal cost that we need to pay to make sure that we actually reach the children who need to be reached.

There is a recent story—and I am just quoting from memory—indicating that a number of school programs, something on the order of 2,000, might have to be shut down under the administration proposal.

It is fruitful to worry about design, but this is one of a small number of absolutely critical public investment programs that we should be loathe to cut.

Chairman **Domenici** Now let me ask all of you—we are working on this deficit, and not necessarily based on Dr. Nordhaus' lesser-of-two-evils approach, should we continue on with deficits or do we reduce them. I think that is how you have analyzed it and said you ought to reduce the deficit. As policymakers, you are recommending that we opt for more capital formation. The concern would be to begin to reduce the budget. The others seemed inclined to be more doctrinaire, I would say.

But in any event, we are being told that if we cut the budget, it is apt to reduce the value of the dollar, which in turn is apt to enhance our foreign trade posture.

And, Dr. Dornbusch, you have talked about the asymmetry in fiscal policies around the world, more spending versus restraint versus ours. But basically, we have had two views. Most say that in reducing the deficit, you will reduce interest rates, which will reduce the dollar, which will increase our foreign trade and lessen our dependence on foreign dollars. But, we have had some concern by at least one witness that the exact opposite might occur, that our economy might get better but that the trade deficit might not be improved.

Where do you come down, Dr. Greenspan?

CAPITAL FLOWS CURRENTLY IN PLACE CANNOT CONTINUE

Dr. Greenspan. I come down on the issue that the evidence is inconclusive, for the following reason. I think Dr. Dornbusch is certainly correct in stipulating that high yields for the U.S. dollar vis-a-vis other currencies clearly moves capital to the United States.

The question, however, is does that explain the level of the dollar, or can it also explain the rise, which has been extraordinary.

I think it is clear that the spread of interest rates between currencies explains the differential between exchange rates, but it is not, in my judgment, the type of evidence which suggests why the dollar is rising.

The reason that the dollar is rising, basically, is that there has been a dramatic decline in the net purchases of foreign currencies by U.S. residents. Since the major credit problem in Mexico in 1982, the net outflow from the United States to foreign countries, specifically through the American commercial banking system, has gone from something in the area of $110 billion-plus in 1982 to probably a negative $40 billion annual rate the second half of last year.

What this suggests is that the exchange rate is very substantially reflective of capital flows, which are initiated for reasons other than interest rates.

Econometric analysis does not suggest very strong correlations between yield differentials and exchange rate differentials, in real terms, and we have just had a recent experience of the American dollar rising in the face of falling interest rates. And then, of course, there is the other side of the problem. If we reduce the deficit, we will significantly reduce interest rates and that will be very important to the economy.

What I would not raise as a promise, however, is that, in and of itself, will lower the exchange rate. The issue is a very complex one. The dollar cannot go up indefinitely, and is likely to come down eventually because I do not believe the capital flows that are currently in place can continue. But I would not argue strenuously that the major reason we wish to reduce the domestic Federal budget deficit is to bring the exchange rate, of the dollar down.

Chairman **Domenici**. Dr. Dornbusch?

Dr. **Dornbusch**. I certainly agree with Dr. Greenspan that the interest rate is not the sole determinant of where the level of the dollar is or the rate of change.

But I was very shocked by the statement of Secretary Baker yesterday, that he has never heard of a country that brought its fiscal affairs in order, to quote him, and had its currency weakened, because if you looked out of the window, you would see Germany and Japan, that have had a dramatic improvement in their fiscal situation and the collapse of their currencies.

Senator **Chiles**. Is that because of the fact that we were sitting here, again, with a different policy, and that currency flowed to us? I mean, why did it happen?

Dr. **Dornbusch**. Let me go ahead and try and answer.

Senator **Sasser**. Mr. Chairman, could Dr. Dornbusch pull that microphone a little closer?

Chairman **Domenici**. Please do, Doctor.

THERE HAS BEEN A SHIFT TOWARD U.S. GOODS

Dr. **Dornbusch**. I do not think we can look either at the current account or at the capital account separately to say here is what moves the dollar. Suppose that American banks had lent to Latin America; then, Latin America would not have been running the noninterest current account surpluses they did. We would have a different situation on capital flows and on the current account.

If the U.S. economy, under the fiscal stimulus, had not moved so fast, U.S. banks could not have lent domestically. They would have looked abroad, and capital flows would have looked differently.

So we cannot look at the interest rate, at the capital account, or the current account, one only, and say here is what moves the dollar. But we can ask what has been happening in the world economy.

We had a shift towards U.S. goods, away from foreign good, because abroad there has been a contraction in fiscal policy, a very strong one, and in the United States, a very sharp expansion.

With an excess demand for U.S. goods, output has increased, and the relative price of U.S. goods has gone up. The relative price of U.S. goods has gone up through the exchange rate.

We are all accustomed to saying that fiscal deficits raise interest rates, but in an open world economy, the primary effect of fiscal deficits is on the real exchange rate, and the crowding out is not so much through the interest rate; it is through the fact that you lose the export sector and the import competing sector. Changing around our fiscal policy, I have no question that the dollar will come down—certainly, if the Federal Reserve maintains our growth rate, lowering interest rates. I do not think the dollar will collapse, because the rest of the world is enjoying the export-led growth. They will lower the interest rates; the decline will be small—10, 15 percent, not 30, 40. We will have growth in manufacturing because we will sell more abroad, and some competitiveness, but mostly stronger growth abroad. A story that would say when we bring our fiscal affairs into order, the dollar would rise further—it is very hard to explain what the U.S. economy looks like with that, because we will have the Great Depression.

Chairman **Domenici**. Dr. Nordhaus.

DEFICIT REDUCTION PACKAGE WILL NOT BRING MAJOR TURNAROUND

Dr. **Nordhaus**. If you were in Las Vegas—Nevada, not New Mexico—where you would put your chips? I would put my chips with Secretary Baker on this one, or maybe with Dr. Greenspan, but not with my colleague, Dr. Dornbusch for the short run of a month or perhaps even a year.

If you look at what has happened to our current account over the last 4 or 5 years, it has moved about $100 billion into deficit. You might ask, what was the reason. Studies indicate that maybe more than half, but not much more than half, came from the high and rising dollar. So that is the most you could turn around.

The second question is, what fraction of the rising dollar was due to the high interest rates. And the strange thing is that the dollar rose through 1982 as relative real interest rates were rising, but then kept rising after the middle of 1982, even as relative real interest rates fell in late 1982 or just bobbled around since then.

Then you further have to ask what fraction of the high real interest rates are due to the Federal deficit. Recent studies, such as one coauthored by a colleague of Dr. Dornbusch, indicate that you cannot attribute all the rise in real interest rates to the high deficit.

So I would say that, on the one hand, that a serious deficit reduction package would tend to push the dollar down. On the other hand, there might be an effect on confidence as well. And I just do not know which of those two would be stronger in the short run. In the longer run, the impact is likely to be for a significant downward effect on the dollar and on our current account deficit.

But I think you would be kidding yourselves if you thought that you were going to get a major turnaround in our current account and trade position from a deficit reduction package of the kind you are anticipating.

Chairman **Domenici**. Does that bring any further comment from either of you?

Dr. **Dornbusch**. I certainly was talking about the dollar, not about the current account. I will say the dollar will not go down a lot, and I think that is something that we agree on. I do not think you would get a huge improvement in the current account, certainly not. But we will get some increase in manufacturing employment; both on the export and on the import side, we will get increases.

Chairman **Domenici**. Dr. Greenspan.

Dr. **Greenspan**. I have no further comment.

Chairman **Domenici**. One last question. We all know about our growing dependence upon foreign money to help us service our big debt and still have some capital left over for the capital needs in the country. Are you saying that a deficit reduction package, sizable in nature, something along the lines of trying to go from 5, 4, 3, 2 percent of GNP, will not change our dependence, or put us in a posture where we would be better off in terms of if there was not as much foreign capital available?

I think you said in the current account issue that you are not sure, but maybe you could answer that one. Dr. Greenspan, maybe what I am asking is, should we be worried about the foreign flow of capital to America which we are using to keep things going turning off suddenly? What effect does a substantial reduction in the deficit have on that fear? Maybe that is a better way to put my question.

ABILITY TO FINANCE CURRENT SERVICES BUDGETS WILL RAPIDLY CHANGE

Dr. GREENSPAN. Mr. Chairman, there is no question that the extraordinary propensity on the part of both foreigners who want to invest in the United States, and residents of the United States who want to invest here, have invested abroad and now no longer want to do so. That has been a very important influence in holding interest rates lower than they would otherwise have been, and clearly made the financing not only of the Federal deficit, but of all financial instrument in this country, a lot easier than it would have been.

When, not if, the desire to move funds into the United States at a $100 billion-plus level, declines for whatever reason—and it eventually must—we are in effect reducing the supply of funds in the United States, and if demand is not correspondingly lowered, interest rates, other things equal, must rise. And the effects could be really quite dramatic

So the issue is not so much what a change in the deficit is going to do to either the flow of capital from abroad, or the exchange rate, but the other way around—namely, that eventually, this extraordinary flow will come to a halt independently of what is going on in the Federal budget. It will therefore mean that our ability to finance the type of current services budget deficit which we are envisioning, with the seeming tranquility will rapidly change. It is important that the Congress endeavor to bring these deficits down substantially before that phenomenon takes hold, because at that point, we will be dealing with a situation which will be economically unstable. Crisis deficit reduction—which I regret seems to be the only way we come at these things—will not be the most efficient or the most desirable.

Chairman DOMENICI. Dr. Dornbusch.

WE SHOULD BORROW TO HAVE GOOD INVESTMENT OPPORTUNITIES

Dr. Dornbusch. Well, I believe there are two issues in your question. The first is what the current inflow of capital helps us to do. I think it helps us to get rid of manufacturing and trade-related activities. While in some sectors, we are investing, in other sectors, firms are going bankrupt. And we will find later that we are very unwise to borrow to make that possible.

The second is, suppose we had a budget cut, suppose there was some movement in the dollar, some adjustment abroad; where would the current account be 2 or 3 years from now. That is the question Professor Nordhaus addressed.

In a study of the U.S. current account, I found that if competitiveness was at the average level of the 1970–84 period, and relative activity in the United States and abroad was at the average of the last 14 years, then our deficit would be 1.5 percent of GNP, instead of 3.

So, if we had a fiscal reduction, activity abroad would certainly rise relative to here, some fall in competitiveness. If we take 1.5 percent of the deficit, as Professor Nordhaus said, it will not disappear; we will not see a surplus.

Should we worry that we borrow abroad? No. If we have good investment opportunities—and that means things other than defense—then we should borrow to have them. They will be partly foreign-owned, but they create employment, and that is ultimately what we are interested in.

Chairman **Domenici**. Dr. Nordhaus.

FOREIGN INVESTMENTS CROWDED OUT

Dr. **Nordhaus**. Let me answer the question in yet a third way. The modern view is that structural Government deficits crowd out investment. The surprising thing to me and to most economists was that the investment that was crowded out in the last 3 years was not domestic investment in tangible equipment, but foreign investment. So, instead of running down our domestic capital stock, we are running down our net stock of foreign investments.

Both of these forms of disinvestment will hurt consumption later. Both of them will mean that in a decade or two, we will be able to consume less. But they have different impacts in the interim. If we reduce domestic investment, then we end up with a smaller domestic capital stock. Instead, we are keeping domestic investment up and slaughtering the trade-exposed sector.

There will be impacts on the real economy from deficits, but we were a little surprised that the impact was not so much on domestic investment—such as housing, plant and equipment—but on net foreign investment, which means the trade-impacted sectors of exports and imports.

Chairman **Domenici**. Thank you very much.

Senator Chiles.

Senator **Chiles**. Dr. Greenspan, we are trying to grapple with a $140 billion trade deficit. It looks like it is a phenomenon that is not going to turn around very quickly. And yet, when you ask people what the consequences are, you get mixed answers.

Is it true that, taking the deficit last year, and what it is this year, and what it is going to be over the next year, that regardless of what that future date is we are reducing the standard of living in this country for ourselves by that amount?

Is that something that, through some action in the future, we can take care of, and we will not ever have to pay the price? It seems we are fueling our interest payments and our deficit with foreign capital now. Is that going to be free, or will there be a price? If so, when do you think we will have to pay it?

WHAT YOU DO WITH THE MONEY BORROWED IS THE CRITICAL QUESTION

Dr. **Greenspan**. Well, first, the figures that are often cited are the book value figures on our international investment position. And it is unclear whether we are about to fall into a net debtor position, if we mark all of the assets on the U.S. investment side to their true market values. But leaving that aside, I think there is no question that if we continue these $100 billion or more current account deficits, that at some point, we will become a net debtor nation.

It is not so much that it affects our immediate standard of living. Less-developed countries with very serious external debt problems require a net transfer of resources to the United States from our debtors to pay interest and principal. Presumably, if the moneys which we borrowed were put to productive uses and created the necessary resources to pay interest and principal, being a net debtor would not effect our standard of living.

In principle, there is no reason why being a debtor nation—as indeed we were in the 19th century—is something which is either positive or negative per se.

The crucial question is, What do you do with the debt? What do you do with the money that you borrow? What is wrong with the Latin American debt problem is that they borrowed money, and instead of employing it for productive purposes which created real resources, to payoff their debt and pay interest, it was essentially used for consumption purposes.

Senator CHILES. What are we doing with it?

Dr. GREENSPAN. I think we are doing precisely what they did.

Senator CHILES. I think so.

Dr. GREENSPAN. Unfortunately, the evidence is now suggesting we have a problem. But it is not debt per se. It is what it is used for.

And if we get into a position where, in effect——

Senator CHILES. I see what you mean. If we borrowed this money and put it into capital expansion, into plants and training there could be a future payoff and it would not be serious. It would be like a business making a loan for capital expansion, and we would be getting some payback.

But of course, that is not what we are doing it for. So how will that bite us? And when will it bite us?

Dr. GREENSPAN. Well, it will bite us in the following way. If we, in fact, use all of the debt, let us assume, for consumption purposes, it will mean at some later point, we will be paying interest which are claims on real American resources. Endeavouring to consume now with externally borrowed money, we will be shifting real U.S. resources in the future, indefinitely——

Senator CHILES. In effect we would have to pay back some dollars that we should otherwise use for capital expansion, that we could use to build our infrastructure and to build the growth potential of the country. That is what you mean when you say the "real" dollars we would have to be paying back, or the "real" money?

Dr. GREENSPAN. Yes, sir.

Senator CHILES. Which, again, means that we are dooming ourselves to a lower standard of living at some future date, even though we cannot put a handle on when that future date is.

Dr. GREENSPAN. Yes. I just would point out, however, Senator, that one could make similar analogies for the domestic economy, as well.

Senator CHILES. Oh, absolutely.

Dr. GREENSPAN. But there is no question that we would begin to look like less-developed country debtors under those conditions.

CORPORATE CLAIMS ABOUT TAX INCENTIVES MAY BE DEAD WRONG

Senator **CHILES**. Dr. Nordhaus, by almost any measure, the corporate share of the tax burden has fallen dramatically over the past two to three decades. Today, many of America's largest corporations either pay no taxes at all, or they get refunds, resulting in negative tax rates.

Stated another way, many of our largest corporations are more profitable after taxes than before taxes. I do not know about you, but that defies the intuitive logic of the nature of the tax system.

We are told repeatedly that the abundant tax breaks to corporations are necessary to spur investment. A recent study of investment patterns of 238 profitable, nonfinancial corporations, between 1981 and 1983, indicates that the corporate claims about tax incentives may be dead wrong. That study concludes that the 50 lowest taxed corporations in the study had an average tax rate over the three years of minus 8.4 percent. That is the 50 lowest taxed. Yet, despite all of the incentives that they took advantage of, they reduced their investment by 21.6 percent. By contrast, the 50 corporations with the highest tax rates increased their investments over the same period by 4.3 percent, while paying 33.1 percent of their profits in Federal income taxes.

I do not know whether that study just happened to find those right corporations or what, but that seems to say, when you look at the 50 lowest and the 50 highest, there was not a correlation, that we were certainly told when we were voting all these incentives that were necessary to get these corporations to make this capital investment.

While few people argue with some provisions of the Tax Code which are beneficial to economic growth, it appears that there are many loopholes that serve only to shelter income from taxes, and do little to stimulate growth and investment.

Of course, former Secretary Regan has admitted that some of the corporate tax breaks may have gone too far. Do you believe that there are some changes that can be made to enhance tax collection from the corporate side that would not harm recovery, and would even help to restore some equity between corporate and individual taxpayers?

STUDY CITED HAS FALLACY IN IT

Dr. **NORDHAUS**. Let me first comment on the issue of whether investment incentives appear to have helped investment, and then take your second question.

I do not recognize the study you quoted, so I cannot comment on it directly. But it does appear to have a fallacy in its design of looking at healthy and unhealthy corporations, rather than the usual methodology to look at what happens over time. It is similar to what I call the Florida fallacy.

Senator **CHILES**. There is no fallacy about Florida that I know of.

Dr. **NORDHAUS**. Well, the Florida statistical fallacy is that, because Florida has a high death rate, it must be an unhealthy place to live.

Senator **CHILES**. Oh, that is a fallacy. [Laughter.]

Dr. NORDHAUS. Yes, that is a fallacy. And I think the study you have cited probably has the same kind of fallacy in it.

Again, I do not want to overstate the precision of economics, but most studies have found that the investment incentives, starting with the investment tax credit in 1962, appear to have bolstered investment in American industry.

This is one reason why I think you should be careful about repealing of the investment tax credit and ACRS system as a way of reducing deficits. This is the pennywise, dollar-foolish argument again: You may be indeed reducing the deficit, but you may be doing it in a way which reduces private investment.

CONSTRUCTIVE WAYS OF WORKING WITH THE CORPORATION INCOME TAX

On the question of whether there are more constructive ways of working with the corporation income tax, let me say a couple of things.

First, there is no doubt that the corporation tax is a bloody mess. I personally think that it is so flawed that we need a new tack on the taxation of corporations. Let me mention two possibilities, not because these are necessarily great ideas, but just to broaden our horizons about corporation taxation:

First, you might broaden the corporation tax base by taxing all capital income, rather than just profits after interest deduction—in other words, to tax property income to corporations rather than just equity income. This would help remove the distortion which drives corporations toward debt and away from equity.

Another possibility would be to change the tax base toward, say corporate net receipts, that is, total receipts less purchases from other corporations. A very low net receipts tax could raise a lot of cash. For example, as I recall the numbers, a one percent tax on corporate net receipts would raise about $40 or $50 billion.

Moreover, if you are concerned about the distributional impacts, you do have to worry about the fact that corporations are a tax shelter. The obvious thing to do there is simply to impute the income from the corporation tax to its shareholders.

There are some modest suggestions. I am a little concerned about the minimum tax, or trading in ACRS for a new model, because these do not serve the objective of raising revenues in a way that does not affect or hurt investment.

Senator CHILES. Those are all my questions, Mr. Chairman.

Chairman DOMENICI. Senator Sasser.

Senator SASSER. Thank you, Mr. Chairman.

Gentlemen, I want to apologize for not being here this morning to hear your opening statements. I very much wanted to be here, but I have never quite mastered the art, Mr. Chairman, of being in three places at one time, which seems to be a necessity around this place. I had three committee meetings going on at one time.

These are not good days for the practitioners of what some have called the dismal science.

I have listened to distinguished economists, including Dr. Greenspan here, for a number of years, tell us that disaster was just around the corner unless something was done about these large,

large budget deficits. And I first started hearing that, I believe, in 1978, when I had been on this committee for about a year. Since that time, the budget deficits have gone up very substantially. It is not an exaggeration to say that they doubled or even tripled in nominal terms, and maybe in real terms, also. Yet we saw last year the highest increase in real disposable income in 21 years. Our gross national product is going up at a very high level. Inflation has been reduced to its lowest level in almost 20 years. Everybody seems to be doing very well, except the farmers and those who have been put out of jobs by imports.

Gentlemen, what has gone wrong? Why do all the economic predictions seem to have gone awry? Why aren't we seeing all the crowding out of private investment by Government borrowing, which was supposed to occur; why aren't real interest rates, that are high enough already, even higher?

Why is unemployment on the rise? Would anybody like to address that question?

Dr. Nordhaus.

HIGHER STRUCTURAL DEFICITS WILL LOWER UNEMPLOYMENT

Dr. **NORDHAUS**. Well, I will just paraphrase what I said before you came in, and that is that many noneconomists are confused about the deficit because they have been the target of scare-mongering sermons over the last few years.

You have been told how high deficits will abort the recovery or raise unemployment. I would stress that such views do not represent mainstream economic wisdom. If you go to the leading textbooks of the land, you will find that they do not say—I repeat, they do not say—that higher structural budget deficits will lower output and raise unemployment. They say that, in the short run, higher structural deficits will lower unemployment, as you have seen for the last 2 years. I cannot say that everybody in the world believes this, but I think that is what conventional wisdom is and has been for 40 years.

Senator **SASSER**. Would that be Keynesian economics?

Dr. **NORDHAUS**. That is modern mainstream macroeconomics. You can put whatever label you want on it. But these are the lessons of the macroeconomic models is, the lessons of the macroeconomic theories, and the lessons of history.

Senator **SASSER**. Sometimes I think President Reagan learned that back in the days of the New Deal when he was a Democrat. We seem to be doing pretty well, Mr. Chairman, now that the President is his own economic adviser and does not have anybody heading up the Council of Economic Advisers.

CEA NOT MOST IMPORTANT INSTITUTION IN U.S. GOVERNMENT

Dr. Greenspan, how important in your judgment is the Council of Economic Advisers? You are a former Chairman of that distinguished group.

Dr. **GREENSPAN**. I think it is important, but I would scarcely argue it is the most important institution in the U.S. Government. It is tremendously important for the President of the United States to get economic advice—hopefully, sound. He has the capacity of getting it from a lot of different places.

It is certainly true that the Council of Economic Advisers has significant advantages over other departments and agencies of the Government to structure analysis in a manner which is useful, in the sense that the CEA does not have any statutory functions which require that it take one position or another.

It is very useful to have an independent quasi-academic institution in the Executive Office of the President to do what, in fact, it is doing.

Having said that, there is a terrible tendency for all of us, including CEA Chairmen, to think that the budget should be cut, but by all means, do not touch the budget of the Council of Economic Advisers. Since I was arguing strongly against increased Government spending and increased deficits back 10 years ago—and I will come to what I think is the answer to your actual question in a minute—I made a very special point of endeavouring to cut the budget of the Council of Economic Advisers at the time.

I might say I do not quite agree with Professor Nordhaus' comments about where a lot of economists have been on this question of the deficit. I indeed, personally, have been arguing it is a very major problem, and I have been arguing it since the late sixties and early seventies. I have never argued that it was a short-term problem.

I think that a number of my colleagues, not quite economists but financial or Treasury officials in the Government, have made statements which I think are not verifiable by any evidence I know. But I do not think economists as such have been arguing that the crowding out issue was a short-term, major problem to create unemployment.

ONE EVENT HAS BEEN SURPRISING

There is, however, one particular event which I do believe has caught us all by surprise, and that is the ability of the United States to create and live with a current account deficit in excess of $100 billion a year. That, I would suspect, has been a problem in forecasting which all of us have fallen over. And I would think that, were we not to have that size of capital inflow into the United States, problems would exist on the budget deficit now. But as I commented in my opening remarks, the Federal budget deficit problem is not a short-term problem. It is a problem which is very serious longer term, and there is nothing, as I see it, inconsistent with the remarks that were being made by a lot of people 10 years ago, 5 years ago, and today, on that question.

I know very few people who were shouting that the economy was about to burn down when the budget deficit went to $50 billion. I do not think that is the case.

I do think it is the case that a number of us, myself included, are very much concerned about the long-term, upward drift in structural deficits. The arithmetic of savings and investment very strongly suggests that unless there is a major shift toward increased savings domestically in the United States, for which there is no evidence, then ultimately, the arithmetic is inexorable. Major problems must arise. What we do not know is when.

Senator SASSER. Yes, Dr. Dornbusch?

POLICIES HAVE BEEN CORRECTED BECAUSE OF INTERNATIONAL REASONS

Dr. DORNBUSCH. I would like to take up both questions. First, to look back at history, the United States, of course, has always been living in an open economy, and though American economics is very provincial, there have been previous instances where domestic macroeconomic policies have been corrected because of international reasons. In 1959, Eisenhower was forced to correct the budget deficits because the Europeans would not have them anymore. In 1968–69, the budget deficit was corrected because the Europeans would not buy the dollars anymore, and in 1979, monetary policy was changed because all the world did not want it anymore.

Senator SASSER. What was changed in 1979?

Dr. DORNBUSCH. Monetary policy; the big move in 1979 happened when Volcker was sent back from the IMF meeting being told, "Change your ways."

So on that accounting, we have until 1989 until something happens. I think that is very sensible, because there is absolutely no emergency. The United States is an excellent credit risk. Our external debt is maybe episilon, maybe zero. We have a small domestic debt. We can go very long as it is. And, because we can go very long as it is, there is absolutely no alarm, and therefore, all the things people said last year here in Washington are not happening. Professor Nordhaus is totally right that old-fashioned, mainline macroeconomics is completely vindicated by the experience of the last 3 years, that fiscal policy expansion rate is good for short-run prosperity—there is no question—and anyone who has argued otherwise was certainly not a mainline academic economist or a business economist for that purpose.

HOW WILL CURRENT DEBT BE PAID

But the question that Dr. Greenspan raises is what could possibly be so bad if we have such a strong recovery, our inflation is coming down, and everybody is smiling. I think the question is how are we ultimately going to pay the debt that we are currently incurring.

There are two questions. One is is the debt that we are incurring somehow paying its own interest? If we are putting it in machines, if we use the foreign money to buy the machines, and the machines are going to pay dividends, then there is absolutely no problem; we just pass it on to them, and there are no tears. Well, we are putting the loans into military expenditure, and we cannot give them used airplane wings in the end. That is our first problem. We have unproductive uses of the deficits, and therefore, we do not have an automatic payment of the external debt service.

The second is that because we run these large deficits and therefore, the dollar is high, we are actually impairing our productive capacity. In 10 years, when we cut our budget deficits, we are releasing resources. But we are releasing them from the defense industry. We will not have the export sector, we will not have the import competing sectors that then could be earning the foreign exchange to pay the foreign debt, or to service it. So we are impairing our actual productive capacity; far from investing in capital that would pay the interest, we are actually destroying the very capital that ultimately has to service the debt. And that is the experience that has happened everywhere in Latin America, where you had overvaluation because of extremely large deficits, externally financed, and then when the IMF came to turn those countries around, they did not have the industries that could have easily earned the dollars to pay the debt. In that direction, we are going. There is nothing Latin American about us yet, but we are going systematically there.

Manufacturing employment has fallen 6 percent. Those are industries that ultimately we will need to service easily the foreign debt. That is the problem Dr. Greenspan raises, and it is certainly there, and it builds up day by day. Today it is nothing. It will go for another 3 years and be much bigger, because the industries will not be there, and then we will have a big, big problem.

Senator SASSER. Well, you could argue that—and I made this argument the other day, I think, to Dr. Volcker—that the Japanese, who run a very large deficit, finance their deficit with internal savings. We run a large deficit and finance it by external borrowing. We use a great deal of this external borrowing to finance our military spending.

To use your analogy of what happened in South America, how are these foreign borrowers going to collect this money from us at some juncture down the line, if we get into devaluation or default? What is going to happen?

Dr. DORNBUSCH. I think there are two possibilities. One is that they will never collect, because in a growing world economy, they want to accumulate U.S. assets. The other is that we get into financial trouble, and we actually get into the hands of the IMF. And then, indeed, we will have to earn it. We will have a depression, and we will look just like Brazil.

Senator SASSER. Well, I gather that it is at least the consensus between Dr. Greenspan and Dr. Dornbusch that one reason for the misjudgment, if you call it that, of many economists has been that we did not take into consideration sufficiently the ability to encourage an inflow of foreign capital into this economy.

Is that a correct assessment?

REASONS AND MOTIVES FOR INVESTING IN THE UNITED STATES NOT UNDERSTOOD

Dr. GREENSPAN. Yes; I think in part.

However, I think one of the things that still remains to be understood is precisely what the motives of foreigners and Americans are with respect to investing in the United States.

It is only when we see what happened, or how important this extraordinary decline since 1982, in net capital outflow by U.S. residents, has been on the dollar that we will fully understand this process.

Dr. Dornbusch said earlier we can explain the rise in the dollar through 1982 as a consequence of a rise in dollar-denominated interest rates relative to others. But since then, that has not been the case, and I think there are other forces at work here which we will not be able to fully understand and analyze until after they are over. As a preliminary judgment, I would suspect that what we are about to see is an end to the liquidation of foreign investments by U.S. residents, which means at that point, there is a decline in the demand for dollars.

Remember, when we talk about safe haven or capital inflow, it is not solely a foreign issue, because Americans have a very major impact on the relative investment in U.S. dollars vis-a-vis other currencies in the world, and Americans, especially our commercial banks, have very sharply swung from very heavy purchases of foreign assets and foreign currencies, with dollars, to in fact a liquidating of that position. And that may be a very important element currently supporting the dollar which, if proved, can only be short term. And when we run through that process, we will know a great deal about the propensity of this economy to be able to finance these very large Federal deficits and other domestic deficits through foreign sourcing.

Senator SASSER. Yes, Dr. Dornbusch.

DOLLAR ASSETS VERY SMALL

Dr. DORNBUSCH. The capital flow problem is very perplexing, because we always have to look for a good reason why someone should be moving a dollar left or right. But if we look at the portfolios of assets that people hold, we will find that for most countries, the fraction of their wealth they now hold in dollar assets is very small, still.

If we look at what has been happening in the world stock market, there has been a boom in the last 2 years. The boom is so large that any additions to their holdings of dollars are very small, compared to the increase in the whole size of the portfolio.

Because the stock markets have increased so much, even our very large deficits have added only very little to their portfolios. I would even guess that the fraction of U.S. assets in foreign portfolios might have declined.

If foreign stock markets rise strongly, there is plenty of room for our dollars, even at the rates at which we are printing them. I think that is an explanation of why the world has so easily absorbed the $100 billion deficit. We always ask where is the next 100 going. Well, if the stock market rises, a good day on the stock market is the same as a year of current account deficits. That, I think, is the explanation.

Senator SASSER. Dr. Nordhaus.

NATIONAL SAVINGS GRADUALLY DECLINING

Dr. NORDHAUS. I would like to put this in a slightly different perspective.

If you look at the long movements in the national savings in this country, you see a slow but gradual erosion of our savings. Going back to the midsixties, net national savings, private savings were a little less than 10 percent of our total output. Private savings include net private investment in tangibles plus net foreign investment. That slid until, by the end of the 1970's, the net national savings rate was about 7.5 percent of output.

In the last 2 years, not withstanding the brave talk about raising savings and so on, the net national savings rate has declined again to 3.5 percent of output.

So we see a fall from about 10 to 3.5 percent, in terms of what fraction of our output we are setting aside for the future. And that is the fundamental issue—that the public dissaving is crowding out private saving.

In terms of the foreign investment, the surprise to just about everyone was that the dissaving did not take the form of less construction of plant and equipment in the United States in the last 3 or 4 years. Rather, the way the dissaving took place was by less foreign investment, through the rising dollar and the big current account deficit. And this was a surprise, as Dr. Greenspan was saying, for just about everyone.

The dissaving would have been domestic investment instead of foreign investment if the dollar had stayed at its 1980 level. But what, in fact, has happened is that crowding out operated on the foreign front. But underlying the broad sweep of events was the predictable fact that a massive increase in public dissavings in the form of a budget deficit has led to an enormous reduction in the fraction of our income that we are setting aside for the future.

Senator **Sasser**. One final question, Mr. Chairman.

Does anybody see a day of reckoning on the horizon in the near future, and if so, what form will this day of reckoning take?

NET FLOW OF CAPITAL INTO THE UNITED STATES COULD REVERSE

Dr. **Greenspan**. Well, Senator, if you are referring to the issue of, is there a day of reckoning on the international flow issue, there may be. The trouble, unfortunately, is that it is almost impossible to forecast.

Let me give you the scenario, as I see it, that could occur. I say "could"—I do not know enough about it to say it will, or even put a probability on it. But what could very well happen is that the evident, significant net flow of capital into the United States to finance our $100-odd billion current account deficit could sharply slow, or even reverse, since a very substantial part of it is emanating from American commercial banks. If that should occur, then we end up with a gap in the supply and demand for savings or credits in the American economy. The initial effect would be a very significant rise in short-term interest rates' which the Federal Reserve could conceivably endeavour to offset, but could only do so by a very major expansion of bank reserves in the system, acceleration of money supply, and a destabilization of our financial system.

So what could occur is an abrupt swing, since a lot of this capital is short-term capital and can move very rapidly. That could be a day of reckoning. It is a scarey type scenario. It is the type of scenario for which there is no real warning. It could occur in 48 hours. And it is the type of thing which I think we should be worried about. The only effective solution that I think the Congress has is to bring down the Federal budget deficit and claims so, in effect, we can afford to significantly reduce our draw, so to speak, on foreign savings.

Senator **Sasser**. Most of these foreign funds that have come into the United States are in a condition, or in such a way that they can be withdrawn very rapidly, they are short-term commitments.

Dr. **Greenspan**. They are very large holdings in the American commercial banking system, either directly with U.S. banks or indirectly through U.S. branches in London and elsewhere, which ultimately are a claim on the United States. But they could be moved rather rapidly if there were a major change in the propensity to hold U.S. dollars.

Senator **Sasser**. Dr. Nordhaus.

SHARP MOVEMENT OF DOLLAR CANNOT BE PREDICTED

Dr. **Nordhaus**. Is there an apocalypse, when? If not now, tomorrow, or next year? There is unlikely to be any apocalypse or any major and sudden shift in our domestic investment patterns. Our capital stock is not going to evaporate overnight. We will see our capital stock growing more slowly, and our living standard therefore will be lower than it otherwise would have been. But it is not going to be any lightning movement.

If in fact there is going to be some rapid change, I think it is in the area of the dollar. I would use the analogy of earthquakes. Seismologists now can predict—or think they can predict—the probability of an earthquake occurrence, say, in California over the next decade or two. And the longer you wait, the more the pressure builds up in the system for an earthquake to occur.

We may be building up tension for rapid movement in the dollar. As we accumulate foreign debt, and as the dollar rises stratospherically further and further above its equilibrium level, we are running the risk of having a rapid movement—not necessarily in a day, or a week, or even in the next year. You could get a very dramatic fall in the dollar at some point. Who knows when? We cannot predict when we are going to have movement on the San Andreas Fault, and similarly, no economist can tell you when the sharp movement of the dollar is going to occur.

Dr. **Dornbusch**. Can I add a remark?

Chairman **Domenici**. Yes; go ahead.

THERE WOULD BE DESPAIR IN EUROPE IF DOLLAR COLLAPSED

Dr. **Dornbusch**. I am a bit disturbed by our tendency to see everything happening in the United States and nothing abroad. It is always good to ask where would all that capital go and why——

Senator **Sasser**. That was a question I wanted to ask, yes.

Dr. **Dornbusch** [continuing]. And what would the rest of the world do if, in fact, the dollar collapsed. I would think that in Europe, there would be despair. European unemployment is extremely high, twice what it was 4 years ago, and it is rising. They are relying on exports to support employment.

If the dollar collapsed, they would be losing their competitiveness. They already think their real wage is too high. The collapse of the dollar would compound the problem. They would immediately lower their interest rates to cushion any fall in the dollar. Imagine Germany, with less than 2-percent inflation—if the dollar falls say 30 percent, in Germany, prices would be falling by 5 percent or so. It would be a terrible thing to that economy. We have to really think what happens on the other side, and we know immediately the dollar cannot collapse, not in 2 or 4 months. Two years is very far out, but at the near term, the Europeans would take their interest rates to zero rather than see a 30-percent fall in the dollar. And every speculator knows that, and therefore, they are not terrified that that could be happening. They are happily sitting there, collecting the extra interest, and saying, "We are going to watch the U.S. Budget Committee, and because we know they are not going to do anything about the budget in a big way, we are safe being parked in dollars." Just as we do not predict that the U.S. stock market tomorrow would collapse, because people could change their minds and hold other assets, I think we should look in the same way at the dollar, ask what are the foreign fundamentals, and they simply do not at this time allow a 30-percent fall in the dollar. Europe is unemployed, and the LDC's are not going to get the U.S. banks to lend to them. And we say the U.S. banks turn around and lend abroad—you have to find someone to borrow. In Europe, investment is zero and has been for 3 years. The LDC's are a poor credit risk, so to whom are those poor banks going to lend? They only can lend in the United States.

DECLINING DOLLAR DOES NOT IMPLY THAT CAPITAL IS GOING ELSEWHERE

Dr. **Greenspan**. Can I just add a footnote on the question of: if the dollar declines, does that imply that capital is going elsewhere? The answer is no. You can get a price adjustment in a portfolio without any movement of capital at all, in the same sense that one never asks, when the price of, say, General Motors, goes up or down in the stock exchange, where did the capital go.

What has happened is there has been a change of valuation. There has been no change in the number of shares. In fact, there are often very significant changes in prices, whether it is in the bond market, the stock market, or the foreign exchange markets, in which no transactions actually take place.

And so, while I do not deny that, in the event the American dollar started to fall vis-a-vis the deutsche mark that the Deutsche Bundesbank would take very significant action to try to fend that off. That is not the same thing as saying that very significant pressures occur. I think what they would have to do is confront themselves with how can they in effect weaken the deutsche mark. And they can do it. What they might well do is to pump a tremendous amount of reserves into the German domestic banking system, which is highly inflationary. It has happened before with them. So I would think that a collapse in the dollar, if it occurs—as I think Dr. Dornbusch correctly points out—is going to have very significant effects not only in the United States, but elsewhere.

However, I would point out that in an attempt to fend off the decline in the dollar, they will be only partly successful. The sort of scare scenario we started with, is a scenario and not a forecast, because no one really can forecast it. There are tremendous potentials for instability in the international financial system which I do not think we have really fathomed at this stage, because we have never seen the consequences of floating exchange rates impacting differentials of purchasing power parities country by country, the way that we are seeing them today.

Chairman **Domenici**. Is that it, Senator?

Senator **Sasser**. That is the end of my questions. If you need to leave, Mr. Chairman——

Chairman **Domenici**. Yes, I need to leave. Why don't you Chair the meeting?

Senator **Sasser** [continuing]. Yes, I have been wanting to Chair this Budget Committee for some time.

Chairman **Domenici**. Yes, why don't you do that?

Senator **Sasser**. We may be able to get a budget resolution out of here, Drs. Dornbusch and Norhaus and Greenspan and I, while you are gone.

FRIGHTENING SCENARIO

Chairman **Domenici**. Having heard their testimony, I think they would have as much trouble agreeing as we do, so I do not think so.

Let me just make one observation. I think the testimony and the questions have been very helpful. And while I understand your propensity to be careful about predictions and the history of deficits has been explained with reference to traditional economics and changes in the last few years, I do think there is one very, very interesting fact. I do not want to ask about it, but I just want to tell you it bothers me very much. While I understand we have been doing quite well with very large deficits, I do note that the Congressional Budget Office has modeled a scenario that shows what would happen in the typical business cycle that you alluded to, Dr. Nordhaus. If we were to have a major recession, and if current policies were as they are, then the deficits assume some far, far different proportions than even the traditional, economists would recognize easily and predict, because it would go to $350 to $450 billion. I don't want to ask about that, because I am ready to leave. But I do think that we would have very few tools at our command at that point. Clearly, at that point I do not believe could you cut the budget. I think at that point, the tradition would be followed that you cannot cut because you are in a terrible position. And if you cannot, I think you do have some real unanswered dangerous potential in it. If nothing else led me to do something about this deficit, that would. I have a lot of other concerns as to why we ought to do something about the deficit, but that one is a very frightening scenario to me, and while I keep saying it will not happen because we are in a decade of prosperity or an era—history defies it; it should happen according to history.

So I think those are two frightening numbers. Now, CBO does assume a very deep recession. I do not mean just the little ones we do not count in the last 7 recessions—sometimes we say 7, or 7½, because one was not so bad. CBO does assume a very big one. I do not want to mislead anyone. But it is still a pretty frightening number.

Thank you very much.

Senator, you can stay as long as you like.

Senator **SASSER**. I think Dr. Dornbusch wanted to make one comment, and then I will be leaving.

FOREIGN REACTION TO FALL IN THE DOLLAR

Dr. **DORNBUSCH**. Yes, I wanted to make a remark about what would be the foreign reaction to a fall in the dollar. If the dollar falls, then abroad, the prices of imports will decline. And the decline in the prices of imports abroad, those currencies will be on the receiving side—exactly what we have experienced the last 4 years. It will give them a lot of leeway for monetary expansion, because their currency appreciation is disinflationary. It really takes their inflation rates down from the already very low levels. In Germany, it is 2 percent; it will come down below zero if there were a big collapse of the dollar. The Bundesbank will be very eager to make inflation, to get it at least up to zero, and that will be the expansion in world activity that we are looking for. If we take the budget action and U.S. interest rates come down, they will look after the dollar so it does not collapse. In the process, they cannot help but create some employment for LDCs and for our export industries, and I think that we are in the stage of the recovery where we should shift in that direction and make them do some of the work.

Senator **SASSER**. Well, gentlemen, thank you very much. I am sure I can speak in the absence of the chairman and express the committee's appreciation for your appearance here today, and I am going to take your statements home and read them with great interest.

Thank you.

[Whereupon, at 12:20 p.m., the committee was adjourned.]

WRITTEN QUESTIONS FROM SENATOR KASTEN TO DR. DORNBUSCH AND THE RESPONSES

Questions. Yesterday, Paul Volcker said that he intends to supply enough money and credit in 1985 for the economy to grow at about a 3.5 to 4 percent rate. The economy, however, shows potential for growing at a faster rate.

Today the Commerce Department reports that the economy grew at a rate of 4.9 percent in the last quarter of 1984. That's a full percentage point higher than they had expected. And, despite the forecasts of many "experts," the economy grew at a rate of 6.9 percent last year. All in all, the economy has grown at about a 6 percent annual rate over the 2 years since the recession trough at the end of 1982—faster than any upturn since 1951.

The budget resolution for fiscal year 1985, too, assumed that the economy would only grow more slowly. It assumed a rate of 5.4 percent in 1984—a full 1.5 percent less than reality.

The administration has forecast a growth rate of 3.9 percent for the next calendar year.

The Federal Reserve also believed that the economy would grow at a slower pace, and hence money was correspondingly tight from April to November of last year.

What are your projections for growth next year?

Do you think the administration's estimate for growth is too conservative?

Do you think that Chairman Volcker's range for economic growth—and hence monetary growth—is too conservative?

What steps can and should we take to get a better indicator of economic performance?

Answers. Dissatisfaction with the ability of "experts" to forecast economic growth can easily be exaggerated. The 4.9 percent growth in the last quarter of 1984, for example, is stated at an annual rate. That means a forecast that was one percent off—again, at an annual rate—was in fact within a quarter of a percent of what actually happened. That margin is surely within the band of error that a prudent user would place around quarterly GNP forecasts.

While any recovery has special features, the 1984 recovery was perhaps even more of a forecast challenge. Real interest rates were unusually high, financial markets were undergoing deregulation, the dollar had reached an all time peak, and fiscal policy was highly stimulatory. Forecasters were taken far away from the standard playground of their models. Accordingly, if they did well they were mostly lucky. Since forecasting relies primarily on drawing lessons from past behavior of the economy the experience of 1985 could not be expected to show forecasting at its best.

The growth potential of the U.S. economy, in the four quarters of 1985, can be judged by historical standards. Since the trough of the recession in the fourth quarter of 1982, we are now in the third year of recovery. The record shows that the present recovery is much stronger than average. Two reasons stand out. First, fiscal policy was far more expansionary than in previous instances. Second, the recession was much deeper. The unemployment rate for males of age 25 and over at the trough of this recession reached 8.6 percent against only 5 percent on average at the trough of the previous six recessions.

TABLE 1.—COMPARATIVE RECOVERIES

	Cumulative growth from trough		3d year growth
	8 quarters	12 quarters	
6 postwar recoveries	9.3	11.2	3.6
Current recovery	12.6	NA	NA

Note.—The 6 postwar recessions included here had troughs in 1954, 1958, 1961, 1970, 1975, 1980 and 1982. The only recession excluded had the trough in the 3rd quarter of 1949.

Barring a nearterm collapse of the dollar, which I think is unlikely, I believe 3 to 4 percent growth in calendar 1985 is quite feasible. The lower range represents the trend growth rate of the economy, the upper range is set by prudence in policy making. There is still slack, but the economy is heading toward full employment and therefore, the speed of the recovery itself starts to affect inflation performance. A collapse of the dollar (say a fall of 30 percent) in the next two quarters could affect performance significantly. In the shortrun the depreciation would do little for net exports. But the very strong inflationary pressure would force the Fed into a restrictive posture thus causing at least a slowdown of growth.

The economy could grow at more than 5 percent for a while, but it would be imprudent to use monetary policy to promote such an expansion. Higher rates of monetary expansion at this stage would merely mean monetizing our overly large deficits. We would experience unsound growth. The correct step at this juncture is to cut budget deficits and combine fiscal restraint with monetary ease to seek longterm, noninflationary expansion rather than a shortlived spurt, that soon and inevitably crashes when money must tighten to preserve the gains in disinflation that have been achieved. The essential step now is to expand capacity and potential output to avoid bottlenecks and to create jobs. That will only happen if real rates of interest come down and business gains the confidence that a year from now demand will still be expanding rather than collapsing in a crunch. A change in our policy mix and a revival of net exports can help build that confidence.

VIEWS OF GROUPS AND ORGANIZATIONS

FRIDAY, FEBRUARY 22, 1985

U.S. SENATE,
COMMITTEE ON THE BUDGET,
Washington, DC.

The committee met, pursuant to notice, at 10:08 a.m., in room SD-608, Dirksen Senate Office Building, Hon. Pete V. Domenici (chairman of the committee) presiding.

Present: Senators Domenici, Kasten, Gorton, Chiles, and Sasser.

Staff present: Stephen Bell, staff director; and Gail Fosler, chief economist.

For the minority: Richard N. Brandon, staff director; and John Hilley, senior economist.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. The committee will please come to order.

This is our final day of hearings on the budget for fiscal year 1986. During the course of the hearings, we have heard from most of the Cabinet Secretaries, Mr. Stockman, and a sample of public groups that are interested in the budget process. Regrettably, we are not going to have time to hear the oral testimony from all groups that either have a valid interest in presenting oral testimony or have an actual interest in the budget itself, such as transit interests, veterans' organizations and a host of others who have asked to testify. We are not going to be able to accommodate them all.

But I would announce that the hearing record is going to be left open for an extended period of time for the submission of written testimony to meet the legitimate concerns of these groups. I hope they will help us understand better the ramifications of the President's suggestions so that we will have a full array of views when we start the final disposition of the process and markup.

Let me welcome our first panel for today, Mr. Alexander Trowbridge, president of the National Association of Manufacturers; Dr. Jack Carlson, executive vice president and chief economist for the National Association of Realtors; Mr. John Koelemij, president of the National Association of Homebuilders; and Mr. Cyril F. Brickfield, the executive director of the National Association of Retired Persons.

We have asked this panel to lead off—we have three panels today—and to discuss with us the President's proposals and the panel's thoughts and feelings and ideas either regarding the President's budget or any other proposals with reference to the budget.

Each of you has actively sought consensus on Federal budget matters within your own organizations . You know how difficult it is to get agreement, and I believe that we have a real opportunity to do something this year. But I must tell you, just as you find it difficult to agree on everything within this budget, we are finding it difficult. That does not mean we will not succeed, just as you have succeeded. We may not end up agreeing with you, but your comments surely will be helpful.

SIMPLE FREEZE WILL NOT ACHIEVE ENOUGH REDUCTIONS

This is the reason that we set aside today to hear your views on appropriate goals for this committee, and we want your views on how we should go about achieving the deficit reduction. Finally, I should say to you as I have said frequently in the past week, that a simple freeze will not get you the same savings as the President proposed in his budget. That is not to say that we should not start with some kind of freeze. But basically, if we are going to get over $50 billion in outlay reductions, we must get there with spending reductions that are above a freeze. We must have either additional program reform, termination or changes, or you will have to add taxes; there is no other way.

I hope your remarks will address whether your organizations are willing to support cuts in programs that may affect your membership directly. I want to thank you in advance for your views and I look forward to hearing your testimony.

We will proceed in the order that I indicated in my opening remarks, if it is all right with you, so we will start with Sandy Trowbridge, president of the National Association of Manufacturers.

Mr. Trowbridge?

STATEMENT OF ALEXANDER B. TROWBRIDGE, PRESIDENT, NATIONAL ASSOCIATION OF MANUFACTURERS

Mr. **Trowbridge.** Thank you, Mr. Chairman.

I am Sandy Trowbridge, president of the National Association of Manufacturers. On behalf of our members, we have presented our views on the President's budget proposals for a number of years, and our recent observations have been fairly consistent.

DEFICIT PROJECTIONS UNACCEPTABLY HIGH

We are very deeply concerned about the huge deficit projections through the end of this decade and believe they must be addressed this year with a major attack on Federal spending. The President's budget makes substantial progress in this regard. We support it as the beginning of a process that will hopefully lead to an even more comprehensive, across-the-board reduction in spending for fiscal 1986.

In augmenting the President's budget proposals, the committee should focus on adding to the spending reductions the President has proposed, not on replacing or watering down his recommendations.

It is painfully clear that the deficit projections through the rest of this decade are unacceptably high. The administration's goal of reducing the deficit to 2 percent of GNP by 1988 has not been met by this budget. The projection has been revised upward to 2.9 percent, and history has shown OMB's past forecasts to have been remarkably sanguine.

SET BUDGET DEFICIT TARGETS

Consequently, we believe that the first action of the Budget Committee should be to agree on setting budget deficit targets at the progressively lower levels of 4 percent, 3 percent, and 2 percent of GNP for fiscal 1986 through 1988. To clearly establish those guidelines would engender strong confidence and support in the business community.

This year's spending priorities are similar to what we have seen in the past 2 years, where the President has allocated increasing resources towards defense. We believe that national security is important, but it must rest on a strong national economy. Entitlements, and Social Security in particular, have emerged virtually unscathed along with the defense budget. This means that about 50 percent of the budget is off limits, and prevents the pain of deficit reduction from being spread even more evenly across all portions of the Federal budget, instead of just the nondefense discretionary spending areas. All are part of the problem; all should be part of the solution.

NEW TAXES WOULD REDUCE GROWTH RATE

NAM is pleased to again note that the President has made public his position against fiscal year 1986 tax increases both during and after his campaign, and we heartily agree with him. New taxes would reduce the rate of growth in the economy, and a slowing economy will automatically trigger the Government's stabilizing expenditures which add to the deficit. The focus should be on spending reductions because that is where the problem is most acute.

Finally, it is critical that this committee act quickly to vote out a budget resolution if possible. We need to act now, because the economy is sufficiently healthy to respond favorably to tighter fiscal policy. That will allow the Federal Reserve to maintain a monetary policy that lowers interest rates and maintains the recovery.

We also need to maintain momentum to make the tough choices that will be necessary, taking advantage of what we see as a broadly-based national consensus that our deficits are simply too high.

ECONOMIC PROBLEMS CAUSED BY DEFICITS

Needless to say, deficits do matter, and they have caused several economic problems over the past few years, which have been brought sharply into focus. I will summarize those problems, which are described in my statement,[1] as follows.

First, business cycle instability—deficits cause expansion of expenditures, pushing prices up, countered by monetary policy which tightens and causes recession.

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[1] See p. 360.

Second, interest rates—deficits create crowding out in the private capital markets, raising the cost of money.

Third, exchange rates—high interest rates attract foreign demand for dollars to invest, raising the dollar's value to the detriment of U.S. exporters.

Fourth, debt service—we lose control of the deficit a's mandatory debt service payments constantly escalate to pay for larger deficits, and fifth, inflation—servicing the deficit can come very often from monetization, thus increasing the pressures for inflation.

INCLUDE DEFENSE AND SOCIAL SECURITY IN DEFICIT REDUCTION EFFORTS

It seems to us clearly easier to identify the problems caused by the deficit than it is to itemize workable solutions. And while NAM supports the President's efforts to bring deficit spending under control, we believe that Congress should go further by the inclusion of defense and Social Security in deficit reduction efforts.

While the degree of cuts in nondefense discretionary spending is important, it alone is not enough. We simply cannot reach our deficit reduction objectives if we leave untouched the two largest elements, defense and Social Security, which jointly comprise over 50 percent of the budget.

IMPLEMENT 1-YEAR FREEZE ON ALL AGGREGATE SPENDING

In order to include all programs in the effort toward deficit reduction, we would advocate that as a first step, a 1-year freeze on all aggregate Federal spending be implemented. The freeze should be comprehensive and equitable. No program should be held unaccountable. In addition, we believe it is important to supplement a freeze with a spending reduction program over the next 3 years.

Any freeze proposal should build on the President's proposals, but also include the following provisions: All cost-of-living adjustments, or COLA's, including those for Social Security, should be frozen in fiscal 1986, followed by increases of less than 100 percent of CPI in subsequent years. To skip a year of COLA adjustments is not to reduce basic existing benefits. It stops payment of a prospective increase, and does on at a time of relatively low inflation.

Second, aggregate spending for nondefense discretionary programs should be frozen at fiscal 1985 levels for at least fiscal year 1986.

Third, all civilian and military pay should be frozen at fiscal 1985 levels for fiscal 1986. Further savings in Federal pension programs can be obtained by making them more comparable to prevailing private sector systems.

We would advocate also a freeze of defense budget authority for 1986 at 1985 levels. The CBO projects increases on baseline spending of about 11 percent per year, through fiscal year 1990, not adjusting for inflation. Surely we can and must ask for a better contribution to deficit reduction than these increases portray.

Farm subsidy programs must be fundamentally reformed to reflect savings comparable to those recommended for other major programs. Means-tested programs should be allowed to adjust for inflation and to accommodate new beneficiaries. However, to the extent possible, the Grace Commission recommendations to improve targeting, efficiency, and management of means-tested programs should be adopted.

DEFICIT IS MOST CRITICAL ECONOMIC PROBLEM

To conclude, NAM views the deficit as a problem of crisis proportions that is made more insidious by the fact that it is difficult for many individual Americans to discern and personally feel the connection between the deficit and the problems it causes. This must not deter us from supporting the President's efforts and to add to them, by reductions in the growth of defense and Social Security expenditures. In this effort, NAM supports you and offers you our wholehearted cooperation.

The business community, to the extent it can speak with one voice, would concur, I believe, that our national deficit, along with its linkage to our balance of trade and payments deficits, is the most critical economic problem facing America today. It will take the concerted and courageous action of all of us to take the required action for a solution.

It happens that today we celebrate George Washington's birthday, and the newspapers appropriately for this week have quoted from his Farewell Address, in which he said:

> The nation must avoid the accumulation of debt not only by shunning occasions of expense, but by vigorous exertions in time of peace to discharge the debt, which unavoidable wars may have occasioned, not ungenerously throwing upon posterity the burden which we ourselves ought to bear.

A voice from 200 years ago to which we can only add "Amen."

Thank you, Mr. Chairman.

Chairman DOMENICI. He could not possibly have imagined the condition we are in, as great as he was, but nonetheless, he said good things.

[The prepared statement of Mr. Trowbridge follows:]

TESTIMONY OF
ALEXANDER B. TROWBRIDGE
ON BEHALF OF THE
NATIONAL ASSOCIATION OF MANUFACTURERS
BEFORE THE
SENATE BUDGET COMMITTEE
ON THE ADMINISTRATION'S FY 1986 BUDGET
FEBRUARY 22, 1985

I am Alexander B. Trowbridge, President of the National Association of Manufacturers (NAM).

The National Association of Manufacturers is a voluntary business association of over 13,000 corporations, large and small, located in every state. Eighty percent of the firms are considered to be small businesses. NAM member companies employ 85 percent of all workers in manufacturing and produce over 80 percent of the nation's manufactured goods. NAM is affiliated with an additional 158,000 businesses through its Associations Council and the National Industrial Council. On behalf of our members, we are pleased to have this opportunity to present our views on the Administration's proposed FY 1986 budget, and our broader recommendations for fiscal policy.

I. INTRODUCTION AND SUMMARY

In this statement, NAM examines the economic implications of the Administration's proposed FY 1986 budget. In our viewpoint, the budget is focused correctly in adhering to the President's position and leaving the existing ERTA tax cuts in place rather than raise revenues through tax increases. Nevertheless, the budget does not adequately address the problem that large deficits are likely to have a series of destabilizing impacts on the economy. In this respect a more appropriate fiscal policy would involve greater spending reductions, particularly in the area of indexed transfer payments, but also in the defense sector. More specifically:

1. The budget is likely to leave the Federal deficit in the area of 5% of GNP until the latter part of the decade. Moreover, in our estimation, the outer year deficits are likely to be higher rather than lower than the Administration forecast.

2. The existence of deficits of this magnitude can have a series of adverse effects on the economy. In terms of the wider implications of the expansionary stance of fiscal policy, the projected deficits for the late 1980s are likely to have a destabilizing impact on the business cycle, and for this reason will create substantial problems of fiscal-monetary coordination. They will contribute to keeping both long and short term interest rates high, through expectational and flow of funds channels. They will contribute to keeping the dollar exchange rate overvalued, primarily by encouraging reserve inflows. Finally, they create the potential for a return to a more destabilizing monetary policy, in the event that policy makers should decide to accommodate

the deficit through reserve money creation. This in turn could be associated with speculative reserve outflows and major fluctuations in interest rates and the exchange rate.

3. Because of the destabilizing implications of the current fiscal policy, NAM presents its suggestions for a more appropriate stance for the Federal budget. We outline a possible fiscal rule for achieving greater macroeconomic stability and suggest improvements in budgetary control procedures that would effectively restore greater discipline to the fiscal process.

4. Finally, the best element of the proposed budget is that it does not impose major new tax increases, at a time when such increases would create a major risk of slowing the economy and weakening the current recovery. In this respect, we present a series of reasons why major tax increases should be avoided at this time, and outline some possible areas where the existing tax system may be due for structural reforms.

II. THE PROPOSED FY 1986 BUDGET: AN OVERVIEW

In terms of its aggregate allocation of funds, the FY 1986 budget represents a considerable change from previous years. The President has proposed freezing programmatic outlays at the 1985 level of $804 billion, with only debt service requirements increasing aggregate nominal outlays. Based upon the assumption of a 4.4% rise in prices in 1986 as measured by the GNP deflator, this amounts to a 3% reduction in real overall spending from FY 1985. The growth rates of real Federal outlays have in this respect been altered significantly with respect to rates witnessed from 1965, when the Vietnam War escalation began, through the 1970s when there was a massive expansion of spending on transfer payments and other social programs. Real Federal spending in 1986 will be even lower than during the 1979 Carter Administration budget, in which real outlays grew by only 1.1%. In sum, progress has been made since 1979 in slowing the growth of Federal outlays, and the 1986 budget would actually go quite farther than in previous years.

In terms of its distribution of priorities by function, the 1986 budget reallocates resources toward defense and social insurance programs. In real terms, defense spending will increase by 6.0%, down from the 9.4% growth rate recorded in 1985. The still significant increases in defense spending are not commensurate with the priority of reducing the deficit, and offset cuts in other areas. Furthermore, little progress will be made in controlling entitlement spending in 1986. Although real discretionary spending for domestic programs will drop 26% in 1986, social security spending will increase by 2% in real terms. This increase will be primarily attributable to indexation provisions, and for this reason modification of current laws on cost of living adjustments could realize substantially greater savings in the area of transfers than what is suggested in the 1986 budget proposals.

Much progress has been achieved in controlling off-budget expenditures which were at 0.7% of Gross National Product (GNP) in 1981, but will amount to only 0.3% of GNP in 1985 and 0.01% in subsequent years. The official estimates for spending on debt service, which project an increase of 6% in 1986, appear to be unreliable. In 1985, real spending on interest payments grew by 13%. The actual figure for debt service is therefore likely to be considerably higher than projected. The underestimation of debt service costs reflects a series of questionable assumptions about the behavior of the economy in 1985-86, primarily that interest rates will decline while real growth is sufficiently rapid to reduce the Federal borrowing requirement.

III. THE DEFICIT ISSUE

Magnitude of the Deficits

By far the most serious problem with the budget, however, has to do with the projected deficits for 1986 and beyond. In the CBO baseline forecast, the ratio of the deficit to GNP is projected at 5.6% in FY 1985, 5.2% in FY 1986, 5.2% in FY 1987, 5.1% in FY 1988 and 5.2% in FY 1989. Thus, throughout the balance of the decade -- and despite reasonably good economic growth assumptions -- the real magnitude of the deficits as expressed as a ratio to GNP will continuously surpass all postwar precedents, assuming projections from the enacted FY 1985 budget.

With the implementation of the Administration's proposed FY 1986 budget, the full deficit (including on and off-budget categories) is projected at 4.3% of GNP in 1986, declining to 3.6% in 1987 and 2.9% in 1988. These estimates are, however, based on inconsistent and implausible long term projections in which the economy undergoes sustained growth at average rates which are unprecedented for postwar business cycles while interest rates continue to decline and the inflation rate remains stable.

All of these projections should be taken with the caveat that forecasting deficits is a somewhat inexact science. In one important respect, the projections of both the Administration and the CBO must be considered as incorporating a substantial margin for error, primarily on the upside. The long term average growth rates projected in both the Administration's and the CBO's economic assumptions do not, of course, approximate the actual year-to-year behavior of the economy, which is characterized by considerably greater cyclical volatility. In this respect, for the average growth rates projected for the 1980s to be realized, the economy would have to experience substantially faster growth rates during the recoveries in order to offset the declines in economic activity during the recessionary periods. From this perspective, the growth rates projected by the Administration are unrealistically high. In NAM's view, 1985 will in fact exhibit slower growth than was visible in 1984, with real GNP rising by 3.5% on a fourth-quarter-to-fourth-quarter basis, well below the growth rates witnessed during prior phases of the current economic expansion and lower than the Administration's estimates.

Two main factors underlie the projection of slower long term growth. 1] The surge of growth from the second quarter of 1983 through the first half of 1984 was due in part to the highly expansionist posture of monetary policy in 1982-83, in which the monetary aggregates were allowed to deviate substantially above their target ranges. With the Federal Reserve now following a less expansionary policy, real growth rates are expected to be slower. 2] The pace of expansion during the first eighteen months of the recovery was due in part to "deferred demand," i.e., spending that had been suppressed during the previous recessionary period. In this respect, the surges in both consumer activity and capital spending that characterized the early part of the current business cycle can be interpreted as cyclic rebounds resulting from the unusual depth of the 1981-82 recession. They must therefore be seen as transitory rather than permanent developments.

Far more serious than the difficulties in sustaining long term growth is the risk of another recession, probably in 1986-1987. If the economy behaves as it has during prior postwar cycles, the current expansionary period should last between three or four years, which would place the next recession starting in late 1986 or early 1987. While there have been occasions on which economic expansion was sustained for longer periods (1961-69 and 1975-79), both of these were somewhat atypical, albeit for different reasons. The boom of the 1960s was propelled in large measure by the Vietnam War, while the expansion of the late 1970s was characterized by highly reflationary monetary policies. Furthermore, both of the prolonged periods of expansion were accompanied by substantial accelerations in the inflation rate. Since the current Administration and the Federal Reserve will probably not allow a comparable rise in the inflation rate during the late 1980s, the implication is that monetary policies will have to turn to restriction, possibly in late 1986, in order to prevent the inflation rate from accelerating. The restrictive policy turn would be associated with another recession, probably in 1987. The consequences of another recession at a time when the budget deficit will be in the range of 5% of GNP already could be to raise the deficit by an additional one to two percentage points of GNP, with the result that the actual budgetary situation during the latter part of the 1980s will be considerably more adverse than is currently projected.

Economic Implications of Large Deficits

The emergence of extremely large deficits during the past few years and the projected deficits for the late 1980s have brought into sharp relief a series of questions as to the economic implications of the stance of fiscal policy.

Business Cycle Instability. In normal macroeconomic theory, the full employment budget is used as a cyclically neutral measure of the impact of fiscal policy on aggregate demand. A budget deficit at full employment implies that fiscal policy is excessively expansionist, confronting policy-makers with an unfavorable choice of alternatives. Accommodating the full employment deficit through looser money leads to overheating of the economy followed by accelerating inflation, while offsetting the deficit through monetary restriction results in "crowding out" and higher interest rates.

Historically, the impact of fiscal policy on the business cycle has tended to be destabilizing roughly from the mid-1960s onward. During the early 1960s when the full employment budget was in balance, the economy converged to its equilibrium growth trajectory with a stable non-accelerating inflation rate in the 1% range. However, beginning with the Vietnam War buildup of the late 1960s and continuing through the following decade and a half, the full employment budget exhibited chronic disequilibrium. During relatively late stages in the business cycle when fiscal policy should have become restrictive in order to prevent the economy from overheating, the stance of fiscal policy remained consistently over-expansionist; the large full employment deficits recorded in 1968, 1972 and 1977-78 are cases in point. The net outcome was the overheating of the economy during the booms of the late 1960s and the early and late 1970s.

Given the current stance of fiscal policy, in the event that monetary policy were to accommodate the deficit, the economy would undergo a temporary surge of rapid growth in 1985-86. However, the strength of demand would also be associated with considerable upward pressure on prices. A further consequence of accommodating the deficit would be a larger balance of payments deficit and reserve outflows through the current account. The dollar would depreciate sharply, which would raise import prices. As the combined impact of import price increases and demand pull pressures on domestic prices were arbitraged into wages, the result would be a major acceleration in the underlying inflation rate. By 1986, the inflation rate would be in the range of 7% to 8%, and would continue to rise unless offset by a countervailing return to monetary restraint. Because of the destabilizing implications of accommodating the deficit, however, the Federal Reserve will probably be forced to lean against the expansionary fiscal posture, with the result that the main impact of the deficit will be to keep interest rates high.

Deficits and Interest Rates. Large deficits are associated with upward pressure on interest rates through two major channels. Short term interest rates, which are determined mainly by market forces, have been raised through flow of funds mechanisms. Long term interest rates, on the other hand, are more dependent on expectations of future rates of inflation and the state of the economy.

With reference specifically to short term rates, in situations where private sector demand for credit is high or savings are small relative to private and public sector demand for credit, large deficits (to the extent they are not financed through money creation) will tend to "crowd out" the private sector in credit markets, leading to higher interest rates. This problem has been particularly acute since 1981, and is likely to be accentuated in upcoming years. The Federal participation rate in capital markets in FY 1980-81 increased to just under 34% of all funds raised. In FY 1982, it surpassed 50%. In FY 1983 it is estimated by the Treasury at over 56% while some private sector estimates have projected that it will be about 60% in 1985-86. The implications of this for short term rates are particularly serious inasmuch as it will coincide with an expanding economy. As the borrowing requirement of the Federal government increasingly comes into conflict with the credit needs of the private sector, this will further raise interest rates and will keep short term interest rates during the upcoming business cycle at levels that are unprecedented for a postwar recovery.

While some commentators have argued that the deficit is not fundamentally responsible for the level of short term rates since 1981, primarily on the grounds that there is no long run correlation between interest rates and deficits, this argument will not hold up under careful scrutiny. There was no long run relationship between deficits and interest rates prior to 1979 for two major reasons. 1] Deficits tended to behave countercyclically, rising during recessions and falling during recoveries. This meant that the Federal government's demand for credit correlated inversely with that of the private sector. 2] Monetary policy normally pegged interest rates at levels that were commensurate with broad accommodation of the Federal borrowing requirement. However, because of the change in Federal Reserve operating procedure in October 1979, prior historical evidence is now substantially irrelevant to the issue of whether deficits have raised short term rates. Since under the New Federal Reserve Policy the money supply rather than interest rates have been controlled, a smaller share of the deficit has been monetized, while a greater share has had to be funded in private capital markets, putting the government in direct competition for funds. In the final analysis, therefore, the overly expansionist fiscal stance in conjunction with monetary policies which have remained essentially anti-inflationary goes quite far in explaining the level of short term rates over the past few years.

With respect to long term rates, the initial impact of the Federal deficits in 1981 appears to have been to engender a rise in inflation expectations. Because financial decision-makers expected the deficits to be accommodated, there was a resultant rise in the expectations premium on long term loans. However, by late 1981, it has become apparent that rather than accommodate the deficits, the Federal Reserve was in fact offsetting them. Nevertheless, this evidently led financial decision-makers to conclude that future interest rates would remain high. This expectation in turn has kept long term interest rates at unusually high levels.

The Misalignment in Exchange Rates. The current mix of tight monetary and loose fiscal policy is the single most important factor responsible for the overvaluation of the dollar since 1981. The rise in U.S. interest rates and the resulting differential in real rates of return vis-a-vis other countries have led to increased world demand for dollars to purchase dollar-denominated financial assets. A related factor has been the increased volume of U.S. government debt instruments issued in global financial markets. In FY 1983, approximately 16% of total issuance of Treasury debt were held by foreign sources. To the extent that the large deficits projected for the balance of the decade cannot be financed by domestic borrowing, they will be financed through continued reserve inflows, thereby keeping the dollar overvalued.

This overvaluation has had a series of adverse effects on both the domestic and global economies. In a purely domestic sense, the misalignment in exchange rates has led to a deterioration in trade competitiveness, yielding a substantial drop in export volume and aggregate economic activity. At the same time, the fall in the relative price of imports associated with the appreciation of the dollar has led to an increase in the ratio of imports to total consumption, further reducing domestic employment. At a global level, the appreciation of the dollar has forced the other industrial countries to apply restrictive policies to prevent further depreciation in their exchange rates, support the balance of payments and mitigate reserve outflows. This was substantially responsible for the prolongation of the world recession in 1981-82, and for the sluggish pace of worldwide recovery in 1983.

Deficits Money Creation, and Inflation. The relationship between the Federal deficit, the rate of growth in the money supply and therefore indirectly the inflation rate has been the object of considerable debate in economic theory. It is generally understood that when deficits are financed through additional money creation, (i.e., if the Federal Reserve creates new bank reserves through purchases of government debt) the resulting increases in the money supply will yield increases in aggregate demand that ultimately lead to an acceleration in inflation. The strongest evidence of this process having taken place in the United States is during the late 1960s when the Vietnam War deficits were financed through excess money creation rather than by raising taxes.

Nevertheless, there is considerably less evidence that this process was significant in explaining the rise in inflation during the 1970s, when the posture of fiscal and monetary policy tended to become increasingly asynchronous. During the recoveries of 1971-73 and 1975-79, the Federal deficit declined on average, at the peak of the business cycle, in 1973 and 1979 when the inflation rate underwent a sharp acceleration, the deficit declined to 1.2% and 1.7% of GNP, respectively. By comparison, during the disinflationary period 1975-76 when monetary conditions were restrictive, the deficit expanded to a peak of 4.5% of GNP. The prognosis is that the relationship between deficits and money creation at this time was considerably weaker than has sometimes been argued. More recently, the stance of fiscal and monetary policy has become completely asymmetric. Since October 1979, when the Federal Reserve went over to a policy of targeting monetary aggregates, the relationship between the money supply and the Federal deficit has been negative by a statistically significant magnitude. Econometric tests for the other industrial countries, and evidence from numerous studies support the conclusion that when the central bank adopts a policy of annual quantitative targets for the money supply, the relationship between fiscal and monetary indicators tends to be negative or negligible.

The emergence of a negative fiscal-monetary relationship since 1979 should not of course be taken to mean that the stance of fiscal policy is not destabilizing. Rather, it means that the Federal Reserve will be obliged to hold to relatively restrictive targets for monetary aggregates in order to prevent an acceleration in inflation from taking place.

IV. TOWARD A MORE APPROPRIATE FISCAL POLICY

Given the foregoing, the most essential priority for Congress in the area of fiscal policy over the next few years is the development of a budgetary program more commensurate with macroeconomic stability. This should consist of a major reduction in deficits achieved primarily through phased cuts in outlays. Such a policy would have a series of beneficial effects on the economy.

First, reductions in outlays will mitigate the current over-expansionary stance of fiscal policy and lower the risk of destabilizing the business cycle. By lowering the amount of fiscal stimulus provided by the budget, it will be possible to bring the economy closer to its long-term equilibrium growth trajectory. In essence, a less stimulative fiscal posture will eliminate the current adverse range of choice between allowing the economy to overheat as it has during prior recoveries, or forcing interest rates to rise through non-accommodation of the fiscal stimulus.

Second, reductions in spending will facilitate a more permanent reduction in interest rates. This will take place through two channels. The reduction in aggregate demand resulting from spending cuts will lead to slower credit demand, and at the same time, lower Federal credit needs will mitigate the "crowding out" problem in capital markets. Moreover, a lower Federal participation rate in credit markets will result in increased capital flows to the private sector and greater credit availability for purchases of housing, durable goods and capital equipment. Therefore, in the long run, lower Federal spending should create the basis for sustainable growth in those manufacturing and other industries which are highly sensitive to interest rates.

Third, reductions in both interest rates and the volume of Treasury securities issued in global financial markets will help to achieve a more realistic exchange rate for the dollar. This will generate an improvement in trade competitiveness, leading ultimately to higher employment. At the same time it will alleviate the balance of payments constraint on demand management in the other industrial countries, enabling them to pursue more expansionary policies, stimulating faster worldwide economic growth.

Procedural Improvements for Fiscal Policy

Controlling deficits will require implementing procedural improvements in the Congressional budgeting process, and greater adherence to fiscal policy rules. Among possible rules that are applicable in the conduct of Federal fiscal policy, one concept originating in stabilization theory that would provide a more stable budgetary posture has to do with targeting the full employment (or standardized employment) deficit. More specifically, Congress should bring the full employment budget into surplus over the next business cycle, and hold it in surplus permanently thereafter. By maintaining the full employment budget in surplus, the asymmetry between fiscal and monetary policy would be substantially reduced. Further, reduction of the deficit to a level commensurate with a permanent surplus at full employment would leave the stance of fiscal policy more compatible with stable economic growth. With the full employment budget in surplus, the actual budget would be in approximate equilibrium over the business cycles: surpluses would occur during periods of high growth, and would effectively offset deficits incurred during recessions. Rather than attempt to achieve this in a single year, however, it would be more desirable to achieve the full employment budget surplus more gradually, for instance, over a period of roughly three years or so. The overall deficit reduction goal of 4, 3, and 2 percent of GNP would effectively accomplish this.

Deficit Reduction Techniques

NAM continues to believe quite strongly that the primary strategy for lowering Federal deficits must be across-the-board reductions in the growth rate of Federal spending. It is also our view that such reductions should be spread as evenly as practicable over all portions of the Federal budget, including Social Security, Medicare and defense spending. To hold certain segments immune from reductions will jeopardize the entire fiscal control process. While the following list is by no means exhaustive, it provides several options which are worthy or consideration.

Curtailment of Entitlement Spending. As a summary of the historical growth of Federal outlays reveals, increases in transfer payments have been largely responsible for the expansion of the public sector over the last decade. Although the growth of transfer payments now appears to be in the process of leveling off and may undergo a modest decline over the next several fiscal years. Nevertheless, the magnitude of the projected decline is sufficiently small that transfers will continue to work against efforts to reduce the deficit, and for this reason greater control over income transfers is clearly required. NAM's recommendations on this issue are twofold. First, no new entitlement programs should be created. Second, all existing indexed income transfers programs, including Social Security, should be indexed to something less than 100% of CPI increases. Here there seem to be two major options: 1] reducing the indexing formula by a specified number of percentage points (e.g., CPI increase minus 3%) or, 2] holding the index to a percentage of CPI increase (e.g., 60% of CPI). Both approaches would produce major savings.

Freeze Proposals. We have in the past supported the concept of freezing Federal spending at current levels (or at current levels plus a modest growth increment) and continue to do so. An enforceable overall freeze may be one of the few techniques for imposing the across-the-board sacrifices against which the normal political process otherwise militates. A possible variation of this technique would be a statutory or constitutional spending limitation which limits aggregate Federal outlays to a specified percentage of GNP. Such a limitation might be more effective if combined with a requirement that there be a greater-than-majority (e.g., 60%) vote in the Congress to permit taxes to be increased faster than the rate of GNP growth.

Limits on Federal Credit Activity. NAM believes that binding limits should be established for all Federal credit activity. Such limits should be enforced through the authorizations and appropriations process, primarily through dollar limitations. Funds for credit activities should also be subject to the same impoundment and reconciliation procedures that are mandated in the Congressional Budget Act for other types of activity. In other words, an equivalent degree of control should be exercised over both direct spending and credit programs.

Procedural Improvements. NAM believes the Congressional budgeting process needs to be strengthened further in order to achieve the fiscal discipline needed to reduce deficits. In order to maintain the integrity of the budget process, enforcement mechanisms such as reconciliation should be improved. The first concurrent resolution should be made binding, while the second concurrent resolution can be eliminated. In addition, Congress should have the option of attaching reconciliation instructions to concurrent budget resolutions. The current statutory ten-day limit for Congress to complete action on a reconciliation bill is insufficient and should be altered. The Budget Committees and Congress should codify the option to include provisions for reducing spending on transfer payments and discretionary items in reconciliation instructions. Finally, the amount of savings achieved in reconciliation bills should be measured on the same basis used by the budget resolution which required them. A final recommendation is that any future deficit reduction package must be structured so that, on a year-by-year basis, no planned tax increase will go into effect until there has been an objective certification (perhaps by the CBO) that planned spending cuts of a greater magnitude than the tax increases have actually occurred.

V. THE QUESTION OF TAX INCREASES

Because tax increases tend to exert an immediate contractionary effect on economic activity, the timing of tax increases over the business cycle is of critical importance to their effects on the economy. If taxes are raised during a period of recession or slow growth, they will tend to produce greater economic slack and perpetuate higher unemployment. In the event that taxes were to be raised this year but the increases were not to take effect until future years, this would require acutely accurate foresight on the part of Congress as to the probable condition of the economy at the time the increases are scheduled to go into effect. Under the circumstances, Congress should defer consideration of any major revenue bills until such time as it is appears the economy can sustain such an increase.

Investment in particular would be likely to suffer as a result of a major tax increase. Throughout the 1970s, businesses were excessively taxed as a result of two factors: the understatement of depreciation costs under ADR, and the overstatement of inventory profits due to inflation. While the Economic Recovery Tax Act of 1981 (ERTA) provided a more realistic system of capital recovery allowances, the tax increases enacted in 1982 and 1984 cut back substantially on these important business investment incentives, which should not further be eroded.

A further argument against enacting tax increases now is that this would represent only a temporary expedient, rather than a systematic reform of the tax system. In the event that Congress enacts legislation substantially altering the tax laws, such a bill should address deficiencies in the current tax laws on a systematic basis, and should produce a more efficient tax structure that is more commensurate with stable economic growth. Rather than rushing into piecemeal and ill-considered tax increases now, it may be more profitable for the Congress to take the time necessary to consider major reform or redirection of the tax system as part of any effort to achieve lower deficits.

In this respect, a major long run problem with the American tax code has been its tendency to penalize savings and investment while subsidizing or otherwise rewarding consumption. The treatment of savings versus consumption in the American tax system is highly atypical of tax codes throughout the industrial countries. Most of the major industrial countries derive a substantial share of their revenue from consumption taxes, most commonly through value-added taxes levied at the successive stages of production. The result is that although the ratio of tax revenues to national income is lower in the United States than in all of the major industrial countries except Switzerland and Japan, the share of revenue derived from direct income taxes (as opposed to indirect consumption-based taxes) in the United States is one of the highest in the industrial world.

The experience of the other industrial countries suggests that there are certain advantages to be gained by taxing consumption rather than income. Because the tax codes of other countries do not penalize investment to the same degree as the United States, these countries generally exhibit a higher level of personal savings and a higher ratio of capital retained. Examples of consumption-based taxes which might be applicable in the United States include either a value-added tax comparable to similar taxes in Western Europe, or a national sales tax. Another alternative is to convert the present income tax system into a consumed income tax by excluding from income taxation the net amount put into savings or investment. NAM does not at this time endorse or recommend any particular type of consumption tax, but we do think that Congress should carefully investigate the possibility of making major structural revisions in our tax laws which would shift the incidence of taxation away from savings and investment, in lieu of making further patchwork revisions to an already unwieldy income tax system.

While the President's FY86 budget projections are not based on any program of comprehensive tax reform it is important to note that the Treasury department's November 1984 tax reform package calls for a 25% to 36% increase in corporate taxes over five years. The bulk of this increase is used to reduce taxes on individuals by roughly the same amount. Essentially, the result is a package which is the aggregate raises no new Federal revenue, but increases corporate taxes substantially.

In our judgment, a major tax increase on the corporate sector is not a good idea. Tax reform should not be viewed as a revenue measure where there are alternatives that do not call for the elimination of an entire network of pro-growth economic policies which presently are contributing to our sustained and vigorous economic recovery. Consequently, any tax reform effort should be revenue neutral with respect to the business sector. If there is a future need to raise Federal revenues, the adoption of a transaction-based consumption tax should be considered.

NAM SUPPORTS DEFENSE FREEZE

Chairman **Domenici**. We are going to ask the questions after the panel is completed, but so that I will know, Sandy, the National Association of Manufacturers, if I read it right, supports that statement that you made as it applies to a defense freeze on budget authority?

Mr. **Trowbridge**. Yes.

Chairman **Domenici**. I would assume that a number of defense contractors belong to the National Association of Manufacturers?

Mr. **Trowbridge**. That is correct, Mr. Chairman.

Chairman **Domenici**. And would it be fair to assume that on that issue, there has been sufficient discussion as to what might be done to live within that freeze?

We are frequently told that people who are proposing a freeze are just picking out a number. Did you discuss what it really meant with some experts?

Mr. **Trowbridge**. We have not been able to, within our own capabilities, go on a line item kind of analysis of the defense budget, because we simply are not that skilled.

Our basic proposition is that a national security must rest on a strong national economy, and this deficit threatens that national economy. We do believe that if there is a freeze using CBO baselines, looking at the 1985 budget resolution, a budget authority, zero real growth for fiscal 1986 would mean about $18.5 billion less, and the outlays at a zero real growth figure, including about 4.5 percent inflation, would be about a $6 billion reduction.

We are using those estimates in an attempt through combining the President's proposals with defense and Social Security reductions to reach about a $53 billion reduction for fiscal 1986.

Chairman **Domenici**. Would it be fair to assume that some of the manufacturers who directly or indirectly benefit from the Eximbank activities are members of your organization?

Mr. **Trowbridge**. They most certainly are.

NAM RESERVES JUDGMENT ON EXIMBANK TERMINATION

Chairman **Domenici**. While you recommend a freeze and include defense and Social Security, the Eximbank is recommended for termination. In supporting the President's budget, is it fair to assume that the association supports that, also?

Mr. **Trowbridge**. We have been looking very carefully at that proposal, because it is really one of the only places in which the Federal Government assists in the competitive battle for American exporters, in a world already very complicated by the overvalued dollar.

We are at the moment trying to estimate the value of their alternative, which is about $100 million of direct subsidies for interest rates that the Eximbank says could generate about $1.8 billion in privately available loans.

Eximbank, in making that, assumes that an organization called Pefco [Private Export Financing Company] is going to be as ready to help the exporter as the Eximbank has been.

We have not had enough experience to know whether that is the case, and we are reserving judgment at the moment. Our attempt is to look at this budget with every possible opportunity for reductions, including those where our members are affected.

Chairman **Domenici**. Thank you very much.

Dr. Carlson.

STATEMENT OF DR. JACK CARLSON, EXECUTIVE OFFICER AND CHIEF ECONOMIST, NATIONAL ASSOCIATION OF REALTORS

Dr. **Carlson**. I am speaking on behalf of the 683,000 members of the National Association of Realtors.

We strongly recommend that Federal Government spending grow less than people's income, and that the growth in tax receipts be limited to the growth in people's income, until a balanced budget at high employment is achieved within 10 years.

RECOMMENDED CUTS AND STRUCTURAL CHANGES

I draw your attention to attachment 1,[1] which has our specific deficit reduction items.

Specifically, we recommend a freeze on all cost-of-living adjustments including Social Security and limit cost-of-living adjustments in subsequent years to follow the most generous practice of the competitive private sector, allowing only up to 60 percent change in the Consumer Price Index, or as a proxy, CPI less 2 percentage points.

Two, freeze defense budget authority in real terms in 1986 and limit real growth to 3 percent in future years, compared by the 2 percent in the Soviet Union, which evidently has just come out in the new CIA estimates during the last 10 years.

Three, freeze nondefense discretionary spending in 1986 and limit outyear increases to inflation or less.

Four, eliminate or curtail at least $16 billion of lower priority programs in 1986 and beyond.

Five, limit tax increases to the growth in people's incomes and design any changes in taxes or tax-like user charges to encourage both long-lived and short-lived investment in housing, homeownership, commerce and industry.

Investment in housing and commercial structures as a percent of GNP has been well below previous recoveries; homeownership has declined since 1980 for the first time in four decades. Only investment in short-lived equipment has improved in this recovery.

Deficit reduction must be planned for several years and must include, as you suggest, more than a freeze. If limited only to 1986, the deficit will only decline in 1986 and then increase every year thereafter and remain greater than 4 percent of GNP or 50 percent of net domestic savings.

LESS DEFICIT SPENDING WOULD HELP AMERICANS

We are convinced that less deficit spending would help Americans in a number of ways.

It would provide a credible start to lower spending to match revenues within 10 years. The financial markets would take note of that. It would lower the deficit gradually so as to continue short-term economic growth and enhance long-term growth.

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[1] See p. 390.

It would reduce the significant risk that the increase in interest payments on the Federal debt will increase annual deficits more than program spending cuts will reduce deficits, thus resulting in an uncontrollable growth of annual deficits and the national debt—probably what George Washington was worried about. By 1984, the annual interest payment added more to the deficit than program spending.

It would provide more investment and provide greater consumption for all generations. The annual deficit if not reduced provides modestly higher consumption now at the expense of significant future consumption on the order of $2 trillion over the next 10 years, or equivalent to $20,000 less consumption for each household within that 10-year period.

It would release savings for investment in housing, commerce, industry, education, training and technological change that is embodied in capital.

It would keep nominal interest rates from rising this year, if it is passed quickly, and reduce nominal and real interest rates in the years ahead.

It would allow greater investment in technological change—as less individual and business savings are taken by government for consumption, more is available for the direct investment needs of people.

It would reduce inflation.

It would increase workers' productivity.

It would increase household income by the order of about $350 by 1988; $800 by 1990, and $1,500 by 1995.

It would correct the Government bias against younger Americans, under 65 years old, as documented in the annual report of the Council of Economic Advisers, page 160 and elsewhere.

It would allow more balanced prosperity for farmers, manufacturers, and service providers.

It would allow reduction in the harmfully high foreign exchange value of the dollar.

It would reduce the huge trade deficit by allowing U.S. export industries and import-competing industries to produce more goods and services and hire more workers.

It would return the United States to a creditor instead of a net debtor nation which will likely lead to less ownership of productive assets by Americans both at home and abroad.

LESS DEFICIT SPENDING WOULD HELP WORLD ECONOMY

We are convinced that less deficit spending would help the world economy; allow worldwide interest rates to decline; investments to rise; jobs to become more available; household incomes to rise; demonstrate to other governments that inflation can be harnessed, employment can grow, household incomes can rise, and the quality of life can improve with wiser government policies.

These significant benefits for citizens of the United States and other countries are enough make it worthwhile to work for deficit reduction.

CUTS IN SPENDING PROGRAMS SUPPORTED

We pledge to help identify and support cuts in spending programs that affect our members and their customers, such as elimination of the Urban Development Action Grant Program, curtailment of the Community Development Block Grant Program, and lower limits on subsidized Federal housing programs.

As we did in 1981 (and it is all in the attachment) and every year since. We have worked to reduce spending in programs that affect us, such as asking the President to veto HUD authorization and appropriation bills that exceeded proposed budgets by $2 to $6 billion. And we have encouraged other associations representing all major industries to do the same.

In a democracy, it is easy to create deficits by greater spending and large tax cuts and difficult to reduce deficits by slower spending. In spite of the courageous leadership of this committee and you, Mr. Chairman, and OMB Director David Stockman and others, the public must now help make it Constitutionally more difficult to continue high deficit spending in the future.

BALANCED BUDGET AND TAX LIMITATION AMENDMENT SUPPORTED

We support enactment by Congress of a balanced budget and tax limitation amendment to require three-fifths vote of the House and Senate either to adopt a deficit budget or to adopt tax increases faster than the growth of people's income or GNP.

Inasmuch as the House of Representatives has been unwilling to address this issue at all in the past, we are working diligently to achieve a two-thirds vote of the State legislatures to call for a Constitutional Convention on this issue. We feel the Congress will act quickly after another State adopts a resolution and thus one State away from the necessary two-thirds.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much.

[The prepared statement of Dr. Carlson follows:]

STATEMENT
on behalf of the
NATIONAL ASSOCIATION OF REALTORS®
regarding
FIRST CONCURRENT BUDGET RESOLUTION FOR FY 1986
to the
SENATE COMMITTEE ON THE BUDGET
by
DR. JACK CARLSON
February 22, 1985

I am Jack Carlson, the Executive Officer and Chief Economist of the NATIONAL ASSOCIATION OF REALTORS®. On behalf of the more than 675,000 members of the National Association, we greatly appreciate the opportunity to testify before the Senate Committee on the Budget as you consider the First Concurrent Budget Resolution for FY 1986. We are pleased to respond to this Committee's request for our views on spending cuts and deficit reduction and their economic impact on the United States and the World.

RECOMMENDATIONS

We strongly recommend that Federal government spending grow less than people's income and that the growth in tax receipts be limited to the growth in people's income until a balanced budget at high employment is achieved within 10 years (see Attachment 1). Specifically, we recommend:

(1) A freeze on all cost-of-living adjustments, including Social Security, and limit cost-of-living adjustments in subsequent years to follow the most generous practice of the competitive private sector -- allowing only up to 60 percent

change in the Consumer Price Index (CPI) or, as a proxy, CPI less two percentage points.

(2) Freeze defense budget authority in real terms in 1986 and limit real growth to 3 percent in future years.

(3) Freeze non-defense discretionary spending in 1986 and limit out year increases to inflation or less.

(4) Eliminate or curtail at least $16 billion of lower priority programs in 1986 and beyond.

(5) Limit tax increases to the growth in people's income (GNP) and design any changes in taxes or tax-like "user charges" to encourage both long-lived and short-lived investment in housing, homeownership, commerce and industry. (Investment in housing and commercial structures as a percent of GNP has been well below previous recoveries; homeownership has declined since 1980 for the first time in four decades. Only investment in short-lived equipment has improved in this recovery (see Attachment 2).

We are convinced that less deficit spending would help Americans (see Attachment 3):

- Provide a credible start to lower spending to match revenues within 10 years (see Attachment 4).
- Lower the deficit gradually so as to continue short term economic growth and enhance long term growth.
- Reduce the significant risk that the increase in interest payments on the Federal debt will increase annual deficits more than program spending cuts will reduce deficits and

thus result in an uncontrollable growth of annual deficits and the national debt (see Attachment 5). (By 1984 the annual interest payment added more to the deficit than program spending.)

- Provide more investment and provide greater consumption for all generations (the annual deficits if not reduced provide modestly higher consumption now at the expense of significant future consumption on the order of $2 trillion over the next 10 years or equivalent to $20,000 less consumption for each household within 10 years).
- Release savings for investment in housing, commerce, industry, education, training, and technological change.
- Keep nominal interest rates from rising this year and next and reduce nominal and real interest rates in the years ahead.
- Allow greater investment and technological change (as less individual and business savings are taken by Government, more is available for the direct investment needs of people).
- Reduce inflation.
- Increase workers' productivity.
- Increase household income by about $350 by 1988, by about $800 by 1990, and by about $1,500 by 1995.
- Correct the government bias against younger Americans (under 65 years old) as documented in the Annual Report of the Council of Economic Advisers, February 1985, p. 160 and elsewhere (see Attachment 6).
- Allow more balanced prosperity for farmers, manufacturers and service providers.

- Allow a reduction in the harmfully high foreign exchange value of the dollar.
- Reduce the huge trade deficit by allowing U.S. export industries and import-competing industries to produce more goods and services and hire more workers.
- Return the U.S. to a creditor instead of a net debtor nation which will likely lead to less ownership of productive assets by Americans both at home and abroad.

We are convinced that less deficit spending would help the world economy:

- Allow world-wide interest rates to decline, investments to rise, jobs to become more available, household incomes to rise (see Attachment 7).
- Demonstrate to other governments that inflation can be harnessed, employment can grow, household incomes can rise, and the quality of life can improve with wise government policies.

These significant benefits for citizens of the United States and other countries are enough to make it worthwhile to work for deficit reduction.

We pledge to help identify and support cuts in spending programs that affect our members and their customers, such as elimination of the Urban Development Action Grant (UDAG) program, curtailment of the Community Development Block Grant (CDBG) program, and lower limits on subsidized Federal Housing Programs.

As we did in 1981 (see Attachment 8), and every year since, we have worked to reduce spending in programs that affect us, such as asking the President to veto HUD Authorization and Appropriations bills that exceeded proposed budgets by $2-$6 billion (see Attachments 9 and 10), and we have encouraged other associations representing all major industries to do the same (see Attachments 11 and 12).

In a democracy it is easy to create deficits by greater spending and large tax cuts and difficult to reduce deficits by slower spending. In spite of the courageous leadership of this Committee, the public must now help make it Constitutionally more difficult to continue high deficit spending in the future. We support Congressional enactment of a Balanced Budget and Tax Limitation Amendment to require three-fifths vote of the House and Senate either to adopt a deficit budget or to adopt tax increases faster than the growth of people's income. Inasmuch as the House of Representatives has been unwilling to address this issue in the past we are working diligently to achieve a two-thirds vote of the State legislatures to call for a Constitutional Convention on this issue. We feel the Congress will act quickly after another state adopts a Resolution and thus one state away from the necessary two-thirds. (This occurred with the 17th Amendment of the Constitution requiring the direct election of U.S. Senators.)

ATTACHMENT 1

Impact of 86 Freeze, Recommended Cuts and Structural Changes Thereafter 1/

	1986	1987	1988	1989	1990	1991	1992	1993	1994	1995
Expected Deficit 2/	215	233	249	272	296	320	343	370	398	430
Impact on:										
Outlays	-33	-57	- 84	-112	-143	-176	-215	-263	-321	-392
Defense	- 6	-16	- 27	- 40	- 55	- 71	- 91	-114	-143	-177
Transfer Payments	- 6	-10	- 17	- 22	- 27	- 31	- 36	- 40	- 49	- 60
Nondefense Discretionary	-18	-22	- 23	- 24	- 25	- 27	- 27	- 31	- 33	- 36
Net Interest	- 3	- 9	- 17	- 26	- 36	- 47	- 61	- 77	- 97	-119
Revenues	-11	- 5	8	11	15	17	19	21	23	25
Deficit	-22	-52	- 92	-123	-158	-193	-234	-284	-344	-417
Resulting Deficit	193	181	157	149	138	127	109	86	54	13
% of GNP	4.6	4.0	3.2	2.8	2.4	2.0	1.6	1.2	0.7	0.2
% of net domestic savings	55.1	47.9	37.8	33.1	28.4	24.2	19.2	14.1	8.3	1.9

SOURCE: NATIONAL ASSOCIATION OF REALTORS®

1/ The 1986 freeze consists of a freeze in real terms of defense budget authority, elimination of COLA's on non-means-tested entitlement programs, and a freeze in real terms of nondefense discretionary spending. Recommended cuts include $16 billion of actual cuts in nondefense discretionary spending recommended by the Administration including the CDBG and UDAG programs. Structural changes refer to 3 percent real growth in defense budget authority, zero real growth in nondefense discretionary outlays, and CPI minus 2 percentage points COLA adjustment to non-means-tested entitlements from 1987 to 1995.

2/ CBO Baseline, February 1985.

ATTACHMENT 2

Impact of the Current and Past Economic Recoveries on Consumption and Investment

	Percent of GNP	
	Average of Six Preceding Recoveries	Current Recovery
Real GNP	---	---
Consumption	61.6	65.4
Durables	7.7	10.4
Nondurables	25.6	24.3
Services	26.2	30.6
Gross Private Fixed Investment	13.9	15.1
Inventories Change	0.6	0.4
Residential	4.5	3.2
Nonresidential	9.4	11.9
Structures	3.7	3.5
Equipment	5.7	8.4
Imports	5.7	10.7
Exports	6.3	10.0
Government Purchases	20.8	21.2
Federal	10.3	8.7
State	10.5	12.5

Note: Current Recovery: 82:4 to 84:4
Previous Recoveries: 49:4 to 51:4, 54:2 to 56:2, 58:1 to 60:1, 60:4 to 62:4, 69:4 to 71:4, 75:1 to 77:1, 82:4 to 84:4.

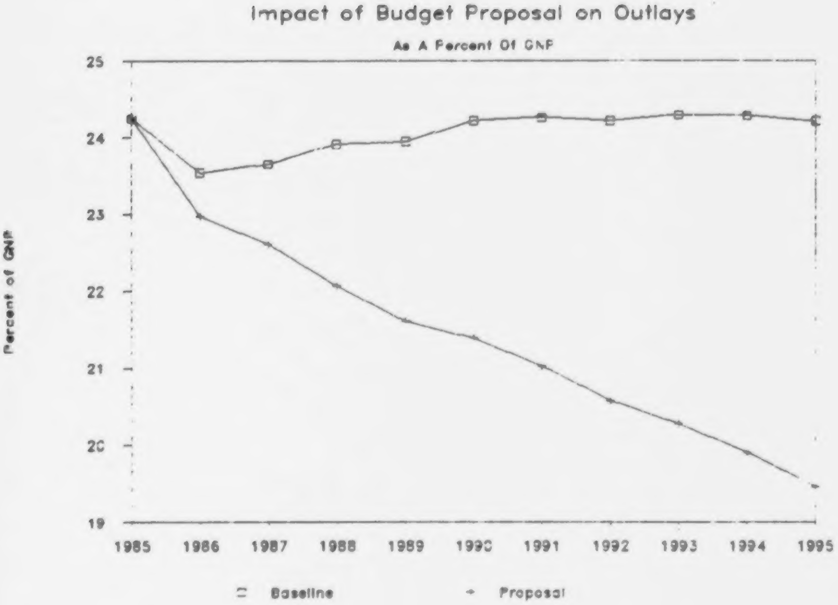
ATTACHMENT 3

Impacts of Proposed Deficit Reduction on the U.S. Economy

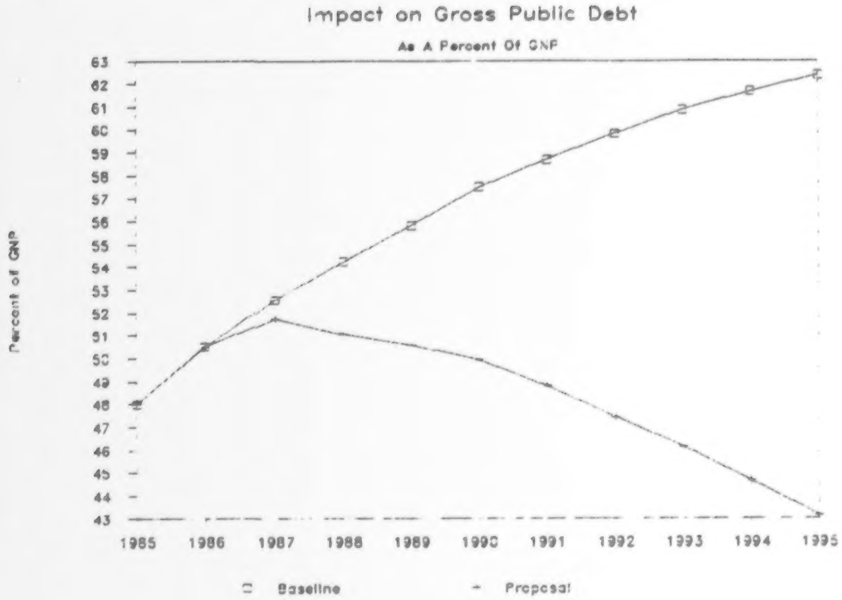
	1988	1990	1995
GNP (1985 Dollars in Billions)	30	68	130
Percent	0.7	1.5	2.5
Mortgage Interest Rates (percentage points)	-1.0	-1.4	-2.2
Employment (millions of jobs)	0.5	0.6	1.1
Percent	0.4	0.5	0.9
Income per Household (1985 Dollars)	350	790	1450
Residential Investment (1985 Dollars in Billions)	11.5	20.8	28.8
Percent	6.8	13.5	18.6
Housing Starts (000's)	150	220	275
Percent	8.2	15.5	22.2
Existing Home Sales (000's)	300	450	600
Percent	10.0	15.0	20.0
Nonresidential Investment (1985 Dollars in Billions)	25.1	60.4	108.9
Percent	4.6	10.4	15.2
Percent of GNP (percentage points)	0.5	1.1	2.0
Equipment (1985 Dollars in Billions)	15.2	37.4	67.6
Percent	4.2	9.9	14.7
Structures (1985 Dollars in Billions)	10.0	23.0	41.3
Percent	5.5	11.6	15.9
Productivity (percent)	0.5	0.9	1.6
Trade-Weighted Value of the Dollar (percent)	-9.6	-10.2	-12.0
Net Exports (1985 Dollars in Billions)	30	43	77
Percent	19.6	29.3	44.5
Inflation (percentage points)	0.3	0.2	-0.6

SOURCE: NATIONAL ASSOCIATION OF REALTORS®

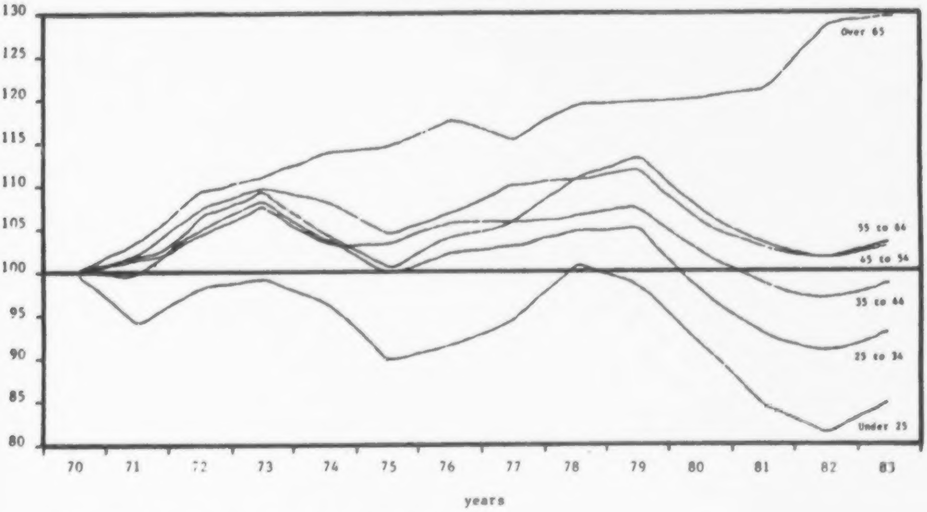
ATTACHMENT 4



ATTACHMENT 5



ATTACHMENT 6



GROWTH IN MEDIAN FAMILY INCOME, ADJUSTED FOR INFLATION, BY AGE OF HOUSEHOLDER (1970 = 100.0)

a/ Adjusted for inflation with the consumer price index.

b/ 1983 estimated.

Source: NATIONAL ASSOCIATION OF REALTORS®, Economics and Research Division. Based on data from the U.S. Bureau of the Census, Current Population Reports, Series P-60, Money Income of Households, Families, and Persons in the United States, U.S. Government Printing Office, Washington, D.C., various years.

ATTACHMENT 7

Impact of U.S. Deficit Reduction on World Economy [1]

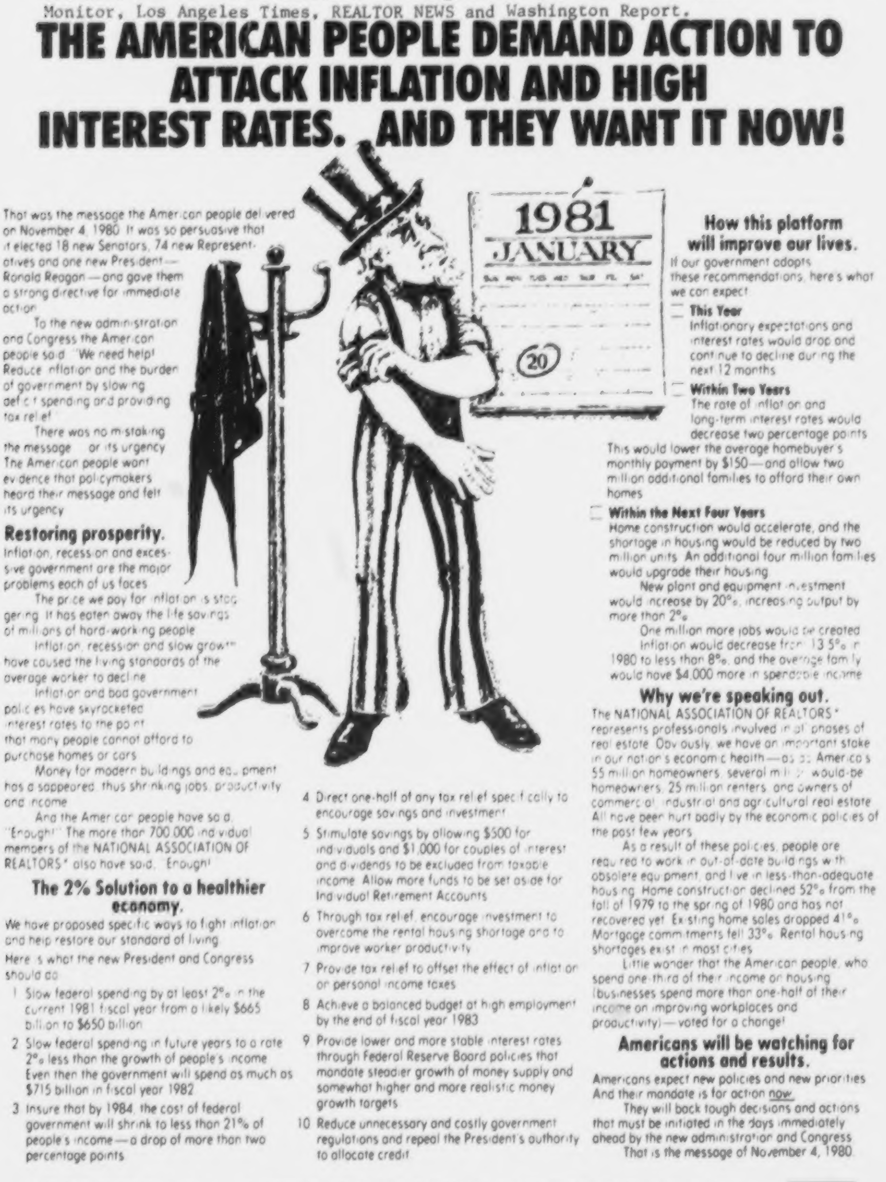
	1988	1990	1995
Gross Domestic Product (percent)	0.5	1.5	2.0
Industrial Production (percent)	2.0	3.6	4.8
Long-Term Interest Rates (percentage points)	-0.8	-1.1	-1.8
Inflation (percentage points)	0.4	0.2	-0.6

SOURCE: NATIONAL ASSOCIATION OF REALTORS®

[1] As measured by impact on major trading partners of the U.S.

Appeared on January 19, 1981 in: The Washington Post, The Wall Street Journal, The New York Times, The Washington Star, Christian Science Monitor, Los Angeles Times, REALTOR NEWS and Washington Report.

ATTACHMENT 8



1981
JANUARY
SUN MON TUES WED THUR FRI SAT
20

THE AMERICAN PEOPLE DEMAND ACTION TO ATTACK INFLATION AND HIGH INTEREST RATES. AND THEY WANT IT NOW!

That was the message the American people delivered on November 4, 1980. It was so persuasive that it elected 18 new Senators, 74 new Representatives and one new President—Ronald Reagan—and gave them a strong directive for immediate action.

To the new administration and Congress the American people said: "We need help! Reduce inflation and the burden of government by slowing deficit spending and providing tax relief."

There was no mistaking the message ... or its urgency. The American people want evidence that policymakers heard their message and felt its urgency.

Restoring prosperity.

Inflation, recession and excessive government are the major problems each of us faces.

The price we pay for inflation is staggering. It has eaten away the life savings of millions of hard-working people.

Inflation, recession and slow growth have caused the living standards of the average worker to decline.

Inflation and bad government policies have skyrocketed interest rates to the point that many people cannot afford to purchase homes or cars.

Money for modern buildings and equipment has disappeared, thus shrinking jobs, productivity and income.

And the American people have said, "Enough!" The more than 700,000 individual members of the NATIONAL ASSOCIATION OF REALTORS® also have said, "Enough!"

The 2% Solution to a healthier economy.

We have proposed specific ways to fight inflation and help restore our standard of living.

Here is what the new President and Congress should do:

1. Slow federal spending by at least 2% in the current 1981 fiscal year from a likely $665 billion to $650 billion.
2. Slow federal spending in future years to a rate 2% less than the growth of people's income. Even then the government will spend as much as $715 billion in fiscal year 1982.
3. Insure that by 1984, the cost of federal government will shrink to less than 21% of people's income—a drop of more than two percentage points.
4. Direct one-half of any tax relief specifically to encourage savings and investment.
5. Stimulate savings by allowing $500 for individuals and $1,000 for couples of interest and dividends to be excluded from taxable income. Allow more funds to be set aside for Individual Retirement Accounts.
6. Through tax relief, encourage investment to overcome the rental housing shortage and to improve worker productivity.
7. Provide tax relief to offset the effect of inflation on personal income taxes.
8. Achieve a balanced budget at high employment by the end of fiscal year 1983.
9. Provide lower and more stable interest rates through Federal Reserve Board policies that mandate steadier growth of money supply and somewhat higher and more realistic money growth targets.
10. Reduce unnecessary and costly government regulations and repeal the President's authority to allocate credit.

How this platform will improve our lives.

If our government adopts these recommendations, here's what we can expect:

☐ **This Year**
Inflationary expectations and interest rates would drop and continue to decline during the next 12 months.

☐ **Within Two Years**
The rate of inflation and long-term interest rates would decrease two percentage points. This would lower the average homebuyer's monthly payment by $150—and allow two million additional families to afford their own homes.

☐ **Within the Next Four Years**
Home construction would accelerate, and the shortage in housing would be reduced by two million units. An additional four million families would upgrade their housing.

New plant and equipment investment would increase by 20%, increasing output by more than 2%.

One million more jobs would be created.

Inflation would decrease from 13.5% in 1980 to less than 8%, and the average family would have $4,000 more in spendable income.

Why we're speaking out.

The NATIONAL ASSOCIATION OF REALTORS® represents professionals involved in all phases of real estate. Obviously, we have an important stake in our nation's economic health—as do America's 55 million homeowners, several million would-be homeowners, 25 million renters, and owners of commercial, industrial and agricultural real estate. All have been hurt badly by the economic policies of the past few years.

As a result of these policies, people are required to work in out-of-date buildings with obsolete equipment, and live in less-than-adequate housing. Home construction declined 52% from the fall of 1979 to the spring of 1980 and has not recovered yet. Existing home sales dropped 41%. Mortgage commitments fell 33%. Rental housing shortages exist in most cities.

Little wonder that the American people, who spend one-third of their income on housing (businesses spend more than one-half of their income on improving workplaces and productivity)—voted for a change!

Americans will be watching for actions and results.

Americans expect new policies and new priorities. And their mandate is for action now.

They will back tough decisions and actions that must be initiated in the days immediately ahead by the new administration and Congress.

That is the message of November 4, 1980.

NATIONAL ASSOCIATION OF REALTORS®
Working for America's property owners.®

REALTOR®

ATTACHMENT 9.1

REALTOR®

NATIONAL ASSOCIATION OF REALTORS
Harley W. Snyder, President
Jack Carlson, Executive Vice President

Albert E. Abrahams, Senior Vice President, Government Affairs
Gil Thurm, Vice President & Legislative Counsel, Government Affairs

Government Affairs Division
777 14th Street, N.W., Washington, D.C. 20005
Telephone 202 383 1000

July 7, 1983

President Ronald Reagan
The White House
Washington, D. C. 20500

Dear Mr. President:

The NATIONAL ASSOCIATION OF REALTORS® supports your intention to veto each Appropriation bill which exceeds the 1983 level adjusted for inflation. Since we believe that the economic growth we are seeing today could not have been realized without the actions of the last two years to reduce federal discretionary spending, we do not want to see a loss of that spending control now.

We are extremely concerned with the lip service given to the issue of deficit reduction. We are convinced that significant action must be taken now to effect a decline in interest rates if they are to fall to their historic level of 3 percent above inflation. We urge you not to let the current evidence of economic growth obscure the fact that maintaining interest rates at this high level, or even higher, threatens the length and strength of the economic recovery.

We expressed our concern by actively supporting Congressman Phil Gramm's efforts to gather House support for your Appropriations vetoes in advance of your actions. We think the Gramm letter is not as strong as the deficit problem warrants, and even though housing may very well be adversely affected short-term, we urge you to veto the Appropriation bill for the Department of Housing and Urban Development. This one Appropriations bill exceeds your budget request by $5.9 billion. It is likely that all of the other twelve Appropriations bills combined will not exceed your budget to the extent of this one bill.

You have requested structural changes in HUD programs which have the potential of providing necessary housing with more controllable expenditures than the staggering long-term costs associated with existing programs. We would like to support you in this effort. However, the best, perhaps the only, way to get Congress to seriously consider such reforms in a HUD Authorization bill is if they are faced with a threatened veto of the HUD Appropriation bill. While we recognize the difficulties facing a HUD Authorization bill this year, we believe it is a reasonable strategy to bring about change in the policy contained in the Authorization bill. Perhaps it can only be accomplished by creating the urgent situation of an Appropriations veto.

While the control of domestic discretionary spending can best be done through a policy of vetoing Appropriations bills, in the long run Cost of Living Adust-

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ATTACHMENT 9.2

ments (COLAs) must be reduced now to curtail future, massive growth of indexed spending programs. We suggest that COLAs be reduced below the full change in the Consumer Price Index (CPI). This is fully merited and fair to compensate for the excessive previous adjustments that are still reflected in the current index level, and to recognize that the index is deficient in its failure to measure changes in the specific goods and services purchased by consumers. Further, it would more closely reflect private industry practice in COLAs for workers. For equity, the indexation of personal income tax brackets could be coupled with similar modification in relation to the CPI. With your support, Congress should consider such a provision being included in any changes in tax and spending Resolutions and Reconciliation bills during the next three months.

We realize the First Budget Resolution for fiscal 1984 does not instruct Congress to make such significant changes in COLAs, but neither does the Resolution require a control of Appropriations bills. We believe that this year the First Budget Resolution should be considered a ceiling for federal programs instead of a floor.

We are making these suggestions to show that we are serious about deficit control. While the actions we propose are not necessarily the only possibility, it is important to take some action to reduce spending more than we raise taxes. Establishing a policy of requiring $2 in spending reduction for each $1 of tax increase necessary for deficit reduction provides essential assurance that we are not returning to the days of higher spending and higher taxation.

Sincerely,

Harley W. Snyder
President

ATTACHMENT 10.1

REALTOR®

NATIONAL ASSOCIATION OF REALTORS®

Donald H. Treadwell, President
Jack Carlson, Executive Vice President

Albert E. Abrahams, Senior Vice President, Government Affairs
Gil Thurm, Vice President & Legislative Counsel, Government Affairs

Government Affairs Division
777 14th Street, N.W., Washington, D.C. 20005-3271
Telephone 202 383 1000

July 16, 1984

President Ronald Reagan
The White House
Washington, D. C. 20500

Dear Mr. President:

The NATIONAL ASSOCIATION OF REALTORS® strongly urges you to veto the Appropriations bill for the Department of Housing and Urban Development. Despite the fact that our membership is affected favorably by some of the provisions contained in the HUD bill more than in any other appropriations bill, we urge a veto since it exceeds your original budget request by $1.875 billion. It is important to indicate by a veto that no excessive spending will be tolerated this year.

We are extremely concerned that the issue of deficit reduction, through spending restraint, is receiving only lip service. In order to reduce interest rates, we strongly believe that significant deficit reduction action must be taken. We urge you not to let the current evidence of economic growth obscure the fact that maintaining interest rates at their current level, or allowing them to edge even higher, threatens the length and strength of the economic recovery.

The promise of reduced interest rates and favorable market reaction through passage of a deficit down-payment package has not been realized. Interest rates have gone up instead. Obviously the small size of the down-payment is a key reason. But also, the modest down-payment was achieved disproportionately with tax increases, including tax increases to disadvantage investment, and 20 percent of all tax increases were disproportionately placed as a burden on real estate.

We strongly deplore the trend of taking incentives away from the private sector while allowing the public sector to increase contrary to your own budgetary goals. Indeed, the tax bill Congress just enacted contains an erosion of your 1981 Economic Recovery Tax Act by lengthening the depreciation period from 15 to 18 years for real estate. We supported your policy of reducing spending in the public sector and increasing incentives for private sector spending and investment. We supported ERTA as the best way to stimulate capital investment, reduce obsolescence of plant and equipment, and encourage a lasting economic recovery -- it still is.

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ATTACHMENT 10.2

For that reason we are dismayed that Congress, with the Administration's blessing, chose this year to increase public sector spending in the HUD appropriations bill and to decrease private sector incentives in the tax bill. The HUD bill alone has $1.875 billion more than you requested while the tax bill increases taxes on the Accelerated Cost Recovery System for real estate by $2.6 billion.

For these reasons, Mr. President, we strongly urge you to refuse this tradeoff at the expense of the private sector, and veto the HUD appropriations bill before you.

Sincerely,

Donald H. Treadwell

Donald H. Treadwell
President

ATTACHMENT 11

NATIONAL ASSOCIATION OF REALTORS

REALTOR®

John R. Wood, President
Julio S. Laguarta, First Vice President
Jack Carlson, Executive Vice President

925 15th Street, N.W., Washington, D.C. 20005
Telephone 202 637 6800

January 21, 1981

Dear Association Member:

For more than 14 months now, the NATIONAL ASSOCIATION OF REALTORS®, on behalf of its more than 750,000 members, has been stressing the effect of poor economic policies on the housing industry.

However, it is not just our industry that has suffered and continues to be damaged by high inflation. Virtually every area of our nation's economy is feeling the burden of the poor mix of fiscal and monetary policies.

On both January 16 and January 19 we offered recommendations to the new administration and Congress and we stressed that we are willing to sacrifice in areas that affect housing and other real estate because in the long run we are confident our industry will benefit.

I am taking this opportunity to ask you to join in this approach -- sacrifice now for future economic strength -- and have enclosed the advertisement we employed and some of our material. First, insist that our government slow overall spending, reduce the federal deficit, provide tax relief directly for encouraging savings and investment as proposed in the attached advertisement we placed in major newspapers January 19. Second, do your part by recommending programs that benefit your industry be trimmed, as we have.

If we can be helpful to you, please call me at 202/637-6891.

Together we can get our economy and our industries back on track. And now is the most appropriate time to begin.

Sincerely,

Jack Carlson

Jack Carlson

Enclosures

ATTACHMENT 12

REALTOR®

NATIONAL ASSOCIATION OF REALTORS®

David D. Roberts, President
Clark E. Wallace, President-elect
William M. Moore, First Vice President

Jack Carlson, Executive Vice President

777 14th Street, N.W., Washington, D.C. 20005
Telephone 202 383 1000

December 12, 1984

Dear Association Member:

There is a consensus across the country and within the government that the federal deficit must be reduced to permit lower interest rates, to increase investment and to provide greater capacity for the economy to grow, thus creating more jobs and providing a higher standard of living and quality of life for all Americans.

The Executive Branch is embarking upon a major effort to lower the deficit by slowing, stopping or reversing the growth of government programs and eliminating programs. The Legislative Branch leaders have indicated their general or specific support for this approach.

We feel it is imperative to join vigorously in this effort to cut low-priority government spending and to do so now and in 1985 during the fiscal year 1986 budget process. We feel, as we did in a letter we shared with you January 21, 1981 (attached), that we not only should support across-the-board spending cuts or freezes but also we must support specific program spending reductions or eliminations, including cuts in programs of interest to our constituencies as evidence of our willingness to identify low-priority programs everywhere. We felt the same way during 1981 and supported more than a one-third cut in budget authority for discretionary programs that were of particular interest to our constituency. We pledge to support such additional spending cuts now and we urge you to do the same.

As we succeed in slowing the growth of government spending we will reduce the pressure to lower the deficit by tax increases, such as those approved in 1984 that are harmful to savings and investment and thus slow the growth of jobs, sales and the American standard of living.

Sincerely,

David D. Roberts
David D. Roberts
President

Jack Carlson
Jack Carlson
Executive Vice President

REALTOR® is a registered collective membership mark which may be used only by real estate professionals who are members of the NATIONAL ASSOCIATION OF REALTORS® and subscribe to its strict Code of Ethics

The NATIONAL ASSOCIATION OF REALTORS® is comprised of more than 1,806 local boards of REALTORS® located in every state of the Union, the District of Columbia, and Puerto Rico. Combined membership of these boards is over 675,000 persons actively engaged in sales, brokerage, management, counselling, and appraisal of residential, commercial, industrial, recreational and farm real estate. The activities of the Association's membership involve all aspects of the real estate industry, such as mortgage banking, home building, and commercial and residential real estate development, including development, construction and sales of condominiums. The Association has the largest membership of any association in the United States concerned with all facets of the real estate industry.

Elected officers are: President David D. Roberts, Mobile, Alabama; President-elect Clark E. Wallace, Moraga, California; First Vice President William M. Moore, Denver, Colorado; Treasurer Phillip C. Stark, Madison, Wisconsin.

The Executive Officer is Jack Carlson.

The Senior Vice President, Government Affairs is Albert E. Abrahams and the Vice President and Legislative Counsel, Government Affairs is Gil Thurm.

Headquarters of the Association are at 430 North Michigan Avenue, Chicago, Illinois 60611. The Washington Office is located at 777 14th Avenue, N.W., Washington, D.C. 20005. Telephone: (202) 383-1000.

REALTOR®

Chairman Domenici. Mr. John Koelemij, president of the National Association of Homebuilders. Welcome.

STATEMENT OF JOHN J. KOELEMIJ, PRESIDENT, NATIONAL ASSOCIATION OF HOMEBUILDERS

Mr. Koelemij. Thank you, Mr. Chairman and members of the committee.

My name is John Koelemij, and it is an honor to appear before you today as president of the National Association of Homebuilders. Indeed, Mr. Chairman, if someone would have suggested to this Dutch lad 40 years ago in wartorn Holland that I would be appearing before this distinguished committee today, representing 130,000 of my fellow American homebuilders, I would have doubted his sanity. But this is indeed a land of opportunity and upward mobility, and we all seek to preserve this hope for the young families of this generation.

I am also a homebuilder of single family and multifamily homes and an owner of rental properties in Tallahassee, FL, and we are proud to be represented by your ranking member, Lawton Chiles, who has been a leader in many areas, especially reduction of the Federal deficit.

EFFORTS TO BRING DEFICIT UNDER CONTROL APPLAUDED

Mr. Chairman, my message today is simple. The homebuilders, home buyers, and renters of this country applaud the efforts of this administration, the Congress, and especially this committee, to bring this deficit monster under control. We endorse the administration's goal of a $50 billion deficit reduction in fiscal year 1986 and a $100 billion deficit by fiscal year 1988. And now, we want to encourage and work with you to remove the obstacles in reaching this goal.

For many years, NAHB has spoken out on the needs to reduce the deficit. And we have supported spending cuts which included severe reductions in housing-related programs, and reluctantly, tax increases, despite their negative impact on housing. For example, from fiscal year 1980 to fiscal year 1985, the budget authority for the Department of Housing and Urban Development was cut by over 50 percent and assisted housing production dropped from 151,000 units to 31,000 units.

Chairman Domenici. Mr. Koelemij, would you back up about 4 minutes in your statement to where you said something nice about Senator Chiles?

Senator Chiles. We arranged it that way so I would not be here. [Laughter.]

Mr. Koelemij. Yes, Mr. Chairman. He would never have received the attention if it had not happened that way.

Chairman Domenici. So you and he snookered me into this. All right. [Laughter.]

Mr. Koelemij. But it is a pleasure to see Senator Chiles here. Good morning, Senator.

Mr. Chairman, as you recall, in 1983, we labeled the deficit America's "ticking time bomb" and launched a national campaign to mobilize popular opinion for deficit reduction efforts. Unfortunately, the time bomb continues to tick. It has not been defused by the inflow of foreign capital, the strength of the dollar, and yes, the ample availability of capital, including mortgage credit. Our industry and the young families who wanted to buy or rent remember 1981 and 1982, and we must avoid a repeat of that catastrophe at all costs.

I am concerned over recent reports of legislative gridlock and lectures on political courage which have dominated the budget news over the past few days. These do not serve to advance the goal which we all seek. It does not take an economist or philosopher to understand why we are having such difficulty achieving the desired result. If you keep defense and Social Security off limits from budget reduction, there is simply not a consensus in Congress or in the country to achieve the $50 billion goal. And I know you are aware of that.

COMPREHENSIVE ACROSS-THE-BOARD FREEZE

That is why we support and intend to work actively for a freeze—a comprehensive, across-the-board freeze, including domestic discretionary spending, all entitlement programs, and national defense. A freeze of that magnitude would save $38.2 billion in outlays for fiscal year 1986 and $82 billion in fiscal year 1988, according to Congressional Budget Office estimates. We believe that if we are serious about deficit reductions, the pain must be spread evenly, taking a little out of each program, so that no one suffers too greatly.

We also realize that a freeze alone will not reach the goal for fiscal year 1986. But we have seen in the past few weeks that most of the programs proposed to be "zeroed out" or severely cut in the administration's budget have important constituencies. And yes, many of these programs serve useful public purposes and provide that proverbial "safety net" for the poor.

CUT DOMESTIC SPENDING 10 PERCENT

We cannot come here, Mr. Chairman, to say that housing assistance is more important than mass transit or Job Corps or the Small Business Administration. But we are prepared to say that we will accept a reduction of 10 percent across the board in all domestic discretionary spending programs beyond the freeze in order to reach the $50 billion goal. Our preliminary analysis shows that a 10 percent cut in domestic spending would save about $17 billion in fiscal year 1986. And in fact, if greater spending cuts beyond the 10 percent are required because the administiation and the Congress feel that some modest increases are essential in national security, then an even higher percentage of across-the-board cuts in domestic spending can be made. But, Mr. Chairman, please do not let the freeze turn into "slush."

HOUSING'S SHARE OF PROPOSED BUDGET REDUCTIONS

Finally, Mr. Chairman, I do want to point out that we do have a number of serious concerns about the impact of the administration's fiscal 1986 budget on housing. According to NAHB estimates, housing's share of the proposed budget reductions represents about $4 billion or 25 percent of the cut in discretionary spending. Given the enormous reductions in housing-related programs since 1980, this is simply not fair or responsive to the growing needs of lower income families and the elderly.

My written statement contains a specific description of the housing-related program reductions, terminations, and imposition of user fees which we must oppose.

DEFICIT REDUCTION PROGRAM CRITERIA

In conclusion, as we analyze the deficit reduction program for fiscal year 1986, we set out three criteria which we believe must be met: First, it must be a substantial reduction in Federal spending, which will serve as a signal to the marketplace to reduce interest rates and sustain economic growth.

Second, it must be fair to all segments of society and to all sectors of the economy, and embody a spirit of shared sacrifice.

Third, it must be politically feasible, capable of bipartisan congressional support and acceptance by the administration, and it should be enacted early this year, and simple and understandable to the American people.

Mr. Chairman, we feel that the program we have outlined, a comprehensive freeze plus an across-the-board spending reduction in domestic discretionary spending meets all three criteria. And frankly, with all due modesty, we have not seen another deficit reduction program which meets these criteria and reaches the $50 billion goal.

Mr. Chairman, we stand ready to work with you, this committee, and the Senate leadership and the administration to reach our common goal.

I thank you for the opportunity to appear, and I hope that my full written statement can be made part of the record and that we may submit some additional tables to complement that.[1]

Mr. DOMENICI. Thank you. Without objection, it will be.

[The prepared statement of Mr. Koelemij follows:]

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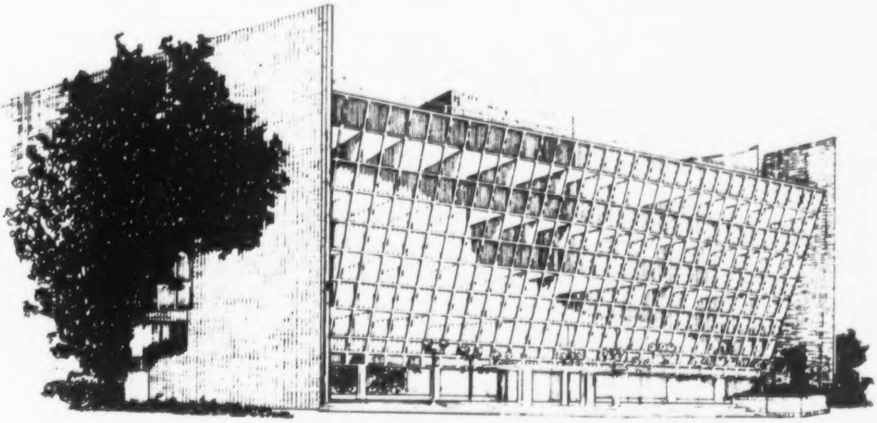
[1] The tables referred to not received at time of printing.

Statement of the NATIONAL ASSOCIATION OF HOME BUILDERS before the

Committee: Senate Budget

Subject: FY'86 Federal Budget

Witness: John J. Koelemij, President
NAHB (Tallahassee, Florida)
Date: February 22, 1985
Place: Room 608 Dirksen Senate
Office Building



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STATEMENT OF
THE NATIONAL ASSOCIATION OF HOME BUILDERS
before the
SENATE BUDGET COMMITTEE
on
FY'86 FEDERAL BUDGET

FEBRUARY 22, 1985

Mr. Chairman, Senator Chiles, and Members of the Committee:

My name is John Koelemij (Kool-am-I) and it is an honor to appear before you today as President of the National Association of Home Builders ("NAHB"). Indeed, Mr. Chairman, if someone would have suggested to this Dutch lad forty years ago in war-torn Holland that I would be appearing before this distinguished Committee today representing 130,000 of my fellow American homebuilders, I would have doubted his sanity. But this is indeed a land of opportunity and upward mobility and we all seek to preserve this hope for the young families of this generation.

I am also a homebuilder of single family and multifamily homes and an owner of rental properties in Tallahassee, Florida, and we are proud to be represented by your Ranking Member Lawton Chiles who has been a leader in many areas, especially reduction of the federal deficit.

Mr. Chairman, my message today is simple. The homebuilders, homebuyers and renters of this country applaud the efforts of this Administration, Congress -- and especially this Committee -- to bring this deficit monster under control. Less than a month ago, I was privileged to sit at the table with the President of the United States, the leaders of this Administration and other industry leaders to discuss the importance of spending cuts as a way to bring down the federal deficit. We applaud the Administration's goal of a $50 billion deficit reduction in FY'86 and a $100 billion deficit by FY'88, and now we want to encourage and work with you to remove the obstacles in reaching this goal. (See Exhibit A -- a resolution unanimously passed by NAHB's Board of Directors on January 21, 1985.) We recognize that this Committee represents the essential first step toward achieving this end ... a goal originally set by the Administration and supported by you, Mr. Chairman, along with bipartisan leadership in the Senate, and Federal Reserve Board Chairman Paul Volcker.

For many years, NAHB has spoken out on the need to reduce the deficit. And we have supported spending cuts which included severe reductions in housing-related programs, and, reluctantly, tax increases in the past two years despite their negative impact on housing. For example, from FY'80 to FY'85 the budget authority for the Department of Housing and Urban Development was cut by over 50 percent and assisted housing production dropped from 151,000 units to 31,000 units (see Exhibit B). Why were we willing to see these events occur? Because housing is the most credit-sensitive sector in the economy, and an economic recovery cannot be sustained over the long-term without a major deficit reduction plan. When housing does well, the economy booms; when the economy sneezes, housing gets pneumonia.

Mr. Chairman, as you recall in 1983 we labeled the deficit America's "ticking time bomb" and launched a national campaign to mobilize popular opinion for deficit reduction efforts. Unfortunately, the "time bomb" continues to tick. It has not been defused by the inflow of foreign capital, the strength of the dollar, and, yes, the ample availability of capital, including mortgage credit. We have only gained a couple of extra minutes on the clock. Our industry -- and the young families who wanted to buy or rent --remember 1981 and 1982 ... and we must avoid a repeat of that catastrophe at all costs. Particularly since we recognize the problem ... and know that a solution exists.

I am concerned over recent reports of legislative gridlock and lectures on political courage which have dominated the budget news over the past few days. These do not serve to advance the goal which we all seek. It does not take an economist or philosopher to understand why we are having such difficulty achieving the desired result. If you keep defense and social security off-limits from budget reduction, there is simply not a consensus in Congress or in the country to achieve the $50 billion goal. And I know you are aware of that. Mr. Chairman, as Adlai Stevenson once said, "Let's talk sense to the American people. Let's tell them the truth, that there are no gains without pains."

That is why we support and actively intend to work for a freeze -- a comprehensive, across-the-board freeze including domestic discretionary spending, all entitlement programs and national defense. A freeze of that magnitude would save $38.2 billion in outlays in FY'86 ... and $82 billion in FY'88, according to Congressional Budget Office estimates (see Exhibit C). We did not come to this position lightly or without healthy discussion by our Board of Directors and leadership. We believe that if we are serious about deficit reduction, the pain must be spread evenly, taking a little out of each program, so that no one suffers too greatly.

We also realize that a freeze alone will not reach the goal for FY'86. But we have seen in the past few weeks that most of the programs proposed to be "zeroed out" or severely cut in the Administration's budget have important constituencies. And, yes, many of these programs serve useful public purposes and provide that proverbial "safety net" for the poor. We cannot come here, Mr. Chairman, to say that housing assistance is more important than mass transit...or Job Corps...or the Small Business Administration. But we are prepared to say that we will accept a reduction of 10 percent across-the-board in all domestic discretionary spending programs beyond the "freeze" in order to reach the $50 billion goal. Our preliminary analysis shows that a 10 percent cut in domestic spending would save about $17 billion in FY'86. We have intentionally given you the $5 billion cushion because we know that the $38 billion target may slip, because of legitimate national security or other considerations. And in fact, if greater spending cuts beyond the 10 percent are required because the Administration and Congress feel that some modest increases are essential in national security, then an even higher percentage of across-the-board cuts in domestic discretionary spending can be made. But Mr. Chairman, please do not let the freeze turn into "slush."

Finally, Mr. Chairman, I do want to point out that we do have a number of serious concerns about the impact of the Administration's FY 86 budget on housing. As I indicated earlier, housing and urban development have already been cut by over 50 percent since 1980. Now they are being singled out for deep reductions or elimination. According to NAHB estimates, housing's share of the proposed budget reductions represents about $4 billion or 25 percent of the cut in discretionary spending. Given the enormous reductions in housing related programs since 1980, this is simply not fair or responsive to the growing needs of lower-income families and the elderly. If these budget reductions were enacted, the HUD budget would drop from 5.3 percent of the total federal budget in FY'80 to 0.7 percent in FY'86 (see Exhibit B).

More specifically, we are not able to support these elements of the Administration's budget:

- A two-year moratorium on housing assistance programs, including newly constructed or rehabilitated housing for low income families and the elderly, as well as housing vouchers.
- Termination of all rural housing and development assistance provided by the Farmers Home Administration.

- Increased user fees on loans guaranteed through the Veterans Administration and loans insured through the Federal Housing Administration. This would increase monthly payments for veterans, first-time homebuyers and other families at the lower end of the housing market. Fees would also be increased on GNMA mortgage-backed securities, and would be imposed for the first time on FNMA and FHLMC, further increasing the cost of homeownership.
- Termination of the Housing Development Grant Program and the Urban Development Action Grant Program.
- Termination of federal grants for sewer construction, a prerequisite for new housing development.
- Termination of the Job Corps Program of the Department of Labor, which trains young people for jobs in the residential construction trades.

As we have made clear already, we do not quarrel with the need to reduce spending, but we question the disproportionate share of cuts proposed for housing by the Administration in the FY'86 budget.

It is with this in mind that we have proposed an across-the-board cut which goes beyond the freeze.

CONCLUSION

In analyzing a deficit reduction program for FY 86, we have set out three criteria which we believe must be met:

- First, it must be a substantial reduction in federal spending, which will serve as a signal to the marketplace to reduce interest rates and sustain economic growth.

- Second, it must be fair to all segments of society and to all sectors of the economy, and embody a spirit of "shared sacrifice."
- Third, it must be politically feasible, capable of bipartisan Congressional support and acceptance by the Administration, enacted early this year, and simple and understandable to the American people.

Mr. Chairman, we feel that the program we have outlined -- a comprehensive freeze plus an across-the-board spending reduction in domestic discretionary spending -- meets all three criteria. And, frankly, with all due modesty, we have not yet seen another deficit reduction program which meets these criteria and reaches the $50 billion goal. Mr. Chairman, we stand ready to work with you, this Committee, the Senate leadership and the Administration to achieve our common goal. The resources of our Association, its members and staff, are available to you and your highly competent staff to resolve the number one problem affecting our national economy.

We urge you to continue to lead this effort, knowing that our 130,000 members -- along with our nation's potential homebuyers, homeowners, renters and housing industry suppliers are ready to follow your lead.

I would be pleased to respond to any questions you may have.

Exhibit A

Resolution No. 21

Date: January 25, 1985
City: Houston, Texas

NAHB Resolution

Title: Budget Freeze
Original Sponsor: Standing Committee on Federal Governmental Affairs

WHEREAS, massive and growing federal budget deficits remain the number one problem affecting our national economy; and

WHEREAS, if no action is taken, deficits will continue in the $200 billion range for the foreseeable future; and

WHEREAS, the economic recovery cannot be sustained over the long-term without a major deficit reduction beginning in FY'86; and

WHEREAS, all areas of government spending should be controlled as part of a program of shared sacrifice; and

WHEREAS, the goal of deficit reduction can only be reached with a bipartisan freeze of all elements of government spending at FY'85 levels; and

WHEREAS, deficit reduction must be the first priority for Congress and the Administration and no tax reform effort should be considered until a deficit reduction plan is enacted; and

NOW, THEREFORE, BE IT RESOLVED that the National Association of Home Builders support, as the first priority of Congress and the Administration, an across-the-board freeze of the total of all spending programs at FY'85 levels, including domestic discretionary spending programs, cost-of-living allowances for entitlement programs, and defense programs, in order to achieve a goal of at least $50 billion in deficit reduction in FY'86 and a deficit of under $100 billion by FY'88,

BE IT FURTHER RESOLVED that NAHB oppose any Congressional action on any comprehensive tax code revision until a major deficit reduction plan is enacted into law.

Board of Directors Action: Approved

EXHIBIT B

DEPARTMENT OF HOUSING & URBAN DEVELOPMENT

BUDGET AUTHORITY AND SUBSIDIZED HOUSING STARTS

(Dollars in Millions)

	1980	1981	1982	1983	1984	1985 (est.)	1986
Budget Authority	35,688	33,353	20,088	15,970	17,924	16,682*	6,971
% of Total Budget	5.3	4.5	2.5	1.8	1.9	2.0	0.7
Housing Starts**	151,000	134,000	113,000	71,000	36,000	31,000	22,000

* Actual budget authority for HUD in 1985 was $31.0 billion. However, this number was inflated by $14.3 billion because of a change in tax law which called into question the tax status of public housing notes. The change caused tax-exempt financing to be suspended and to be replaced by direct federal loans.

** Includes Section 8 new construction, Section 202, Section 235, Section 236, Public and Indian Housing.

Compiled by the National Association of Home Builders from information provided by the Department of Housing & Urban Development and Historical Tables, Budget of the U.S. Government, Fiscal Year 1986.

EXHIBIT C

COMPREHENSIVE ACROSS-THE BOARD FREEZE

(Savings in Billions)

CATEGORY	OUTLAY SAVINGS FY'86	OUTLAY SAVINGS FY'87	OUTLAY SAVINGS FY'88
Freeze COLAs on Entitlements[1]	- 9.4	-12.9	-13.3
Medicare & Medicaid Provider Freezes	- 4.2	- 6.3	- 8.7
Discretionary Appropriations Programs Budget Authority Freeze	- 3.4	- 5.5	- 6.7
Congressionally Appropriated Entitlements[2] Budget Authority Freeze	- .2	- .2	- .2
Discretionary Loan Programs[3] Loan Level Freeze	- .3	- .4	- .6
Disrectionary Trust Fund Programs[4] Obligations Freeze	- .5	- 1.1	- 1.4
Defense Budget Authority Freeze	-20.2	-35.4	-51.1
TOTAL OUTLAY SAVINGS	-38.2	-61.8	-82.0

[1] "Entitlements" include Social Security, means-tested programs, veterans benefits, other COLAs including civilian pay raise.

[2] "Congressionally Appropriated Entitlements" include social service block grants, handicapped and rehabilitation services, foster care and adoption assistance, women infant children (WIC) feeding program.

[3] "Discretionary Loan Programs" include subsidized agriculture credit, rural housing, rural development, Export-Import Bank, Rural Electrification Administration, Small Business Administration.

[4] "Discrectionary Trust Fund Programs" include airport and airway, highway trust fund, administrative expenses for Social Security, SSI, medicare.

NON-DEFENSE DISCRETIONARY SPENDING

FY'86	FY'87	FY'88
$171 Billion	$181 Billion	$190 Billion

10 Percent Across-the-Board Cut FY'86 - $17.1 Billion
15 Percent Across-the-Board Cut FY'87 - $25.6 Billion

Compiled by National Association of Home Builders from Congressional Budget Office estimates.

Chairman DOMENICI. Mr. Brickfield.

STATEMENT OF CYRIL F. BRICKFIELD, EXECUTIVE DIRECTOR, AMERICAN ASSOCIATION OF RETIRED PERSONS

Mr. BRICKFIELD. Thank you, Mr. Chairman.

I am the last speaker—and I listened to all of them. And they talked about this being George Washington's Birthday—and I am sure we are all proud of our first President. But I would like to bring to the attention of the committee that this is also the 50th anniversary of Social Security. It began in 1935, and this is 1985. And I heard these gentlemen, all three of them, say that they are willing to freeze the elderly's inflation protection. That is what a freeze would do. It would freeze inflation protection.

Social Security is one of the great social programs of our century, and it is a family program. If we are going to be fair and willing to share the pain, then they should also be willing to have industry share some of its inflation protection; inflation protection that it gets through subsidies and preferential tax treatment. They should be willing to freeze or suspend tax subsidies for a year, if we are talking about fairness and effectiveness.

Mr. Chairman, I would like to go with my short statement; I have a full statement for the record, and I have some charts.[1]

Chairman DOMENICI. Please.

Mr. BRICKFIELD. Thank you, Mr. Chairman. My name is Cy Brickfield. I am the executive director of the American Association of Retired Persons. We have over 18 million members.

Chairman DOMENICI. Do you have a good staff?

Mr. BRICKFIELD. We have a fine staff, and in fact, we lost one last week to Senator Moynihan's office, so I think we are a good resource organization.

Senator CHILES. That is all right. They have taken them from our staff before, too.

Chairman DOMENICI. Oh, that is right. So it works both ways.

DEFICIT IDENTIFIED AS CHIEF ECONOMIC CONCERN

Mr. BRICKFIELD. We want to see the deficit reduced, and a poll of our members and our leadership identified the deficit as a chief economic concern today. In part, this is because of their concern that the economy will eventually sour. And if the economy sours, the Social Security and Medicare trust funds would sour, as we saw during the late seventies and the early eighties, and a sour economy risks erosion of older persons' purchasing power from other sources of income, such as pensions and savings.

But there is also, Senator, a more basic issue. Older persons do not want to see huge debt passed on to their children. Because of these concerns, AARP has supported responsible deficit reduction plans in the past. We supported TEFRA in 1982, and we supported the Deficit Reduction Act of 1984, as well as several other budget resolutions.

We did so not because they spared older persons from sacrifice, but because on balance they contained more good than ill. But just as we want action taken to reduce the deficit, we are equally concerned about how it is reduced. In evaluating any deficit reduction package, we will look, as we have in the past, at whether the package is both fair and effective.

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[1] See p. 423.

To be fair, the package should recognize sacrifices already made, and since any package will not be painless, how that pain is distributed.

ELDERLY VERSUS NONELDERLY HOUSEHOLD INCOME

On this point, I want to highlight a couple of concerns related to the elderly's ability to bear further burdens. Frankly, we have become increasingly annoyed with efforts by some to portray older Americans as well off. The facts just do not support such a rosy picture. Unquestionably, the economic status of older Americans has improved over the past two decades, and we can all take pride in that. Nonetheless, as chart 2 here shows,[1] elderly household income still lags behind that of the nonelderly.

As you can see, in chart 3,[2] those over $20,000, the elderly come up short, and when you put it the other way around, Senator, for those $10,000 or less, the elderly are again a loser .

In fact, the elderly median household income is only half that of the nonelderly.

SOCIAL SECURITY BENEFICIARIES AT LOWER END OF INCOME SCALE

Now, as chart 5 shows,[3] Social Security beneficiaries are clustered at the lower end of the income scale. Some 14 percent are either below or at the poverty line. And I am going to tell you, Senator, if I might digress a moment, if you freeze Social Security for 1 year, that will push another half a million into poverty.

OLDER PERSONS SPENDING MORE FOR HEALTH CARE

To make matters worse, as chart 4 shows,[4] older persons are spending more and more of their income for out-of-pocket health care costs, not only due to rising costs under Medicare, but 55 percent of their health care bill which Medicare does not cover. And the key line here—and I am sure you are familiar with the $1,550 a year for out-of-pocket payments—it is talking about the percentage, and it is going up gradually, and if you follow down the end of the chart, it goes up and up.

And I could spend some time, but I know I have 5 minutes.

LOOK AT PROGRAMS FORCING DEFICIT UP

To be effective, then, any deficit reduction must address these forces which are driving up the deficit. And I must say to you, as the President himself noted, Social Security is not adding to the deficit. And he also said at that press conference that we could more profitably spend our time looking at the forces that are driving the deficit up. They are the rapid rate of increases in defense spending and the loss of revenue due to the Tax Act of the last 3 years——

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[1] See p. 428.

[2] See p. 429.

[3] See p. 434.

[4] See p. 431.

Chairman **Domenici**. Wait, now. The President did not say the last part, did he?

Mr. **Brickfield**. No. Well, I will quote him almost verbatim.

It is true, Senator, I may have gone a little too far. But he did say we could more profitably spend our time looking at the programs that are forcing the deficit up.

Chairman **Domenici**. End of statement. Fine.

FORCES ATTRIBUTABLE TO DRIVING UP DEFICIT

Mr. **Brickfield**. End of statement. Then I move over to the CBO, chart 6.[5] It says that the two main forces driving the deficit up are these two first lines, namely, the tax reductions, which is attributable for $1 trillion, and also the increases in defense spending, which is attributable for half a trillion dollars.

The only real reduction has been in non-defense spending in the last three years, and that is the savings, and that is half a trillion.

Since fiscal 1982 through 1990, the deficit has been cut by half a trillion on the domestic side. That is the 551. Unfortunately, over $1 trillion has been added on the deficits due to excessive revenue-losing provisions, and another $400 billion has been added by the defense increases, and yet another $400 billion is due to higher interest costs.

CHANGE DIRECTION OF FEDERAL POLICY

As chart 7 shows,[6] the effect of all this has been drastically to change the direction of Federal policy. Defense spending and interest costs, the last two columns on the right, are rising, while entitlement programs, the two columns on the left, including this so-called uncontrollable Social Security you hear so much about, they are declining, as are other domestic spending.

So I am concluding, if there is to be an effective deficit reduction package, it has to contain several things. We should apply, Senators, the same scrutiny to defense spending as we have applied to nondefense spending. There has got to be a reduction in the rate of growth.

Second, we should restore the revenue base to a fiscally prudent level. The Federal Government provides subsidies on both the spending and the tax sides of the budget. A benefit is a benefit, whether it is on the expenditure side or on the revenue side.

GIVEAWAYS HAVE GROWN ON TAX SIDE

Over the past several years, the cutbacks have been primarily on the spending side, while the giveaways have grown, believe me, on the tax side. In fact, five of the Nation's large corporations—and you know this—General Electric, Boeing, Dow Chemical, TENECO, Santa Fe, and Southern Pacific—paid no corporate taxes at all during the last 3 years, while generating profits of over $13 billion. And during that same period, they received $1 billion in tax rebates. You cannot ask Social Security beneficiaries to sacrifice a COLA, or absorb higher medical costs and not ask for sacrifice from those who are lined up at the tax subsidy window.

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[5] See p. 438.
[6] See p. 439.

REDUCE RISING HEALTH CARE COSTS

Savings can be made on the domestic side, and that is in the area of health care. We think you can cut the costs and still keep the care. We can and should reduce the rising costs of health care, but not through cost-shifting, which just changes the address on the medical bill and does not address the problem.

So let me say that we appreciate the opportunity to be here. All Americans, regardless of age, surely, have a stake in finding a solution to the deficit. And ultimately, we hope that we can work together to find a solution—true, that none of us will like, but all of us can support—and which the public can view to be both fair and effective.

I thank you.

Chairman DOMENICI. Thank you very much.

[The prepared statement of Mr. Brickfield follows:]

AARP

TESTIMONY OF

CYRIL F. BRICKFIELD
EXECUTIVE DIRECTOR - AARP

before the

SENATE BUDGET COMMITTEE

February 22, 1985

On behalf of the American Association of Retired Persons, I want to express our appreciation for the opportunity to testify before the committee on deficit reduction.

This committee hardly needs another recitation of the current and potential economic effects of larger and larger deficits on the country and all its citizens, young and old. Suffice to say, these large and growing deficits propel us into uncharted waters, a course which is both risky and unnecessary.

Older persons have a major stake in the debate over the deficit and how to reduce it. Our members and volunteer leadership view the deficit as the chief economic concern of older persons--a status previously reserved for inflation. To ignore the deficit--to accept the status quo--threatens older persons just as much as some proposals to reduce it. Why:

First of all, large and growing deficits threaten to sour the economy. In that scenario, programs on which the elderly rely will be jeopardized. The trust funds supporting Social Security and Medicare are particularly sensitive to economic ups and downs as we saw only a few years ago. Indeed, the trust funds remain within a stone's throw of trouble.

Secondly, a sour economy risks erosion of the elderly's purchasing power from other, nongovernment, sources of income. For example, the elevated inflation rates of the late 70's and early 80's cut into the value of their savings, pensions, and other sources of retirement income just as surely as any budget cut.

Third, is the family concern: Simply put, our members don't want to see a huge debt passed to their children and grandchildren. For many older persons, this intergenerational or family concern may be more powerful than all the economic arguments which are made on behalf of deficit reduction.

For these reasons, AARP and its members have consistently urged the President and the Congress to reduce the deficit, and supported responsible efforts to do so: TEFRA in 1982; the Deficit Reduction Act of 1984; and several Budget Resolutions in both Houses. We have supported these measures not because they exempted older persons from additional burdens, but because, on balance, there was more good than ill, both on the tax and spending sides of the ledger.

But, just as we are concerned that the deficit be reduced, we are also concerned about how it is done. In considering how to address the deficit and what role older persons may play we have several concerns--not in order to create roadblocks, but rather to identify areas in which might seek better understanding and hopefully accord.

First, is the economic condition of older Americans. A concern which frankly is heightened by stories that attempt to portray older Americans as well off.

There is no question but that the economic status of today's elderly has improved from what it was 10 to 15 years ago. That represents major progress in which the Congress and successive Administrations, both Republican and Democratic, can take great pride. In 1970 one in four older persons lived in poverty. That was reduced to 14% in the late 70's approximately, where it now stands. In fact, as illustrated in Chart 1 most of the reduction in the aged poverty rate was due to the large ad hoc increases in Social Security which occurred prior to the automatic cost-of-living adjustments (COLA). The Social Security COLA has enabled those 3 to 4 million elderly who hover just above the poverty line--particularly the over 2 million within 125% of poverty--from falling below it.

But, despite progress, the income situation of older Americans is still far behind that of the non-elderly. To state or even imply as some have recently, that the elderly are now on a par or even better off economically is misleading.

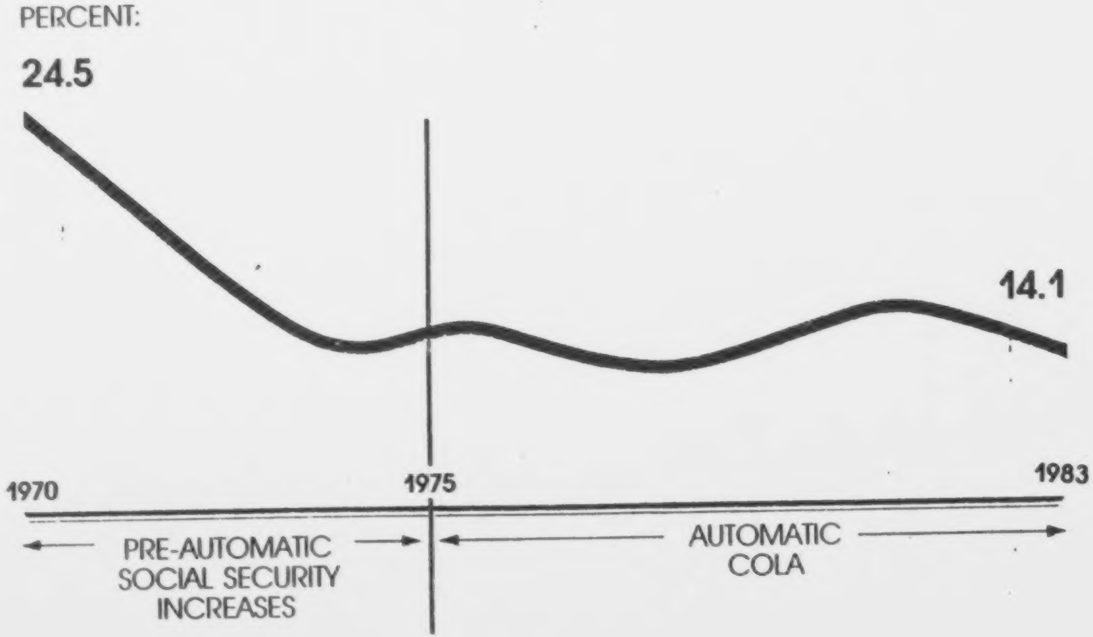
--Median household income of the elderly is only half that of the non-elderly. In 1983, median elderly household income stood at $11,718; median non-elderly household income stood at $23,865. (Chart 2) Moreover, while almost 60% on non-elderly household income was at $20,000 or more slightly less than 27% of elderly household incomes stood at $20,000 or more. (Chart 3)

--Older persons still have the highest poverty rate of any adult age group. (14.1%)

--Elderly women living alone experience a 33% poverty rate. Median income for this group was $5,600 in 1983 just $800 above the poverty threshold. (Dependency on Social Security among this group is in

Chart 1

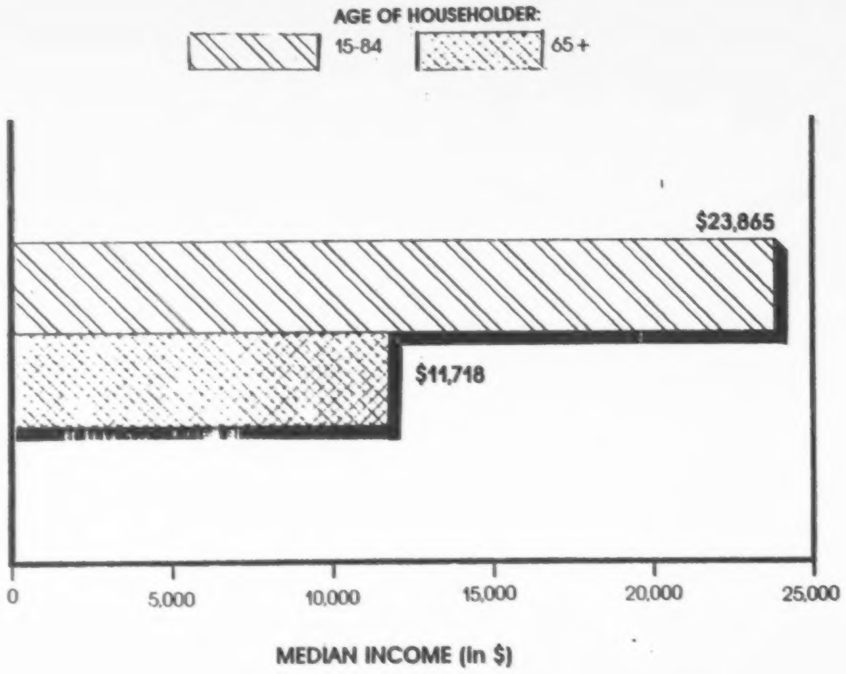
POVERTY RATE
(Age 65+)



Source: U.S. Bureau of the Census, 1984

Chart 2

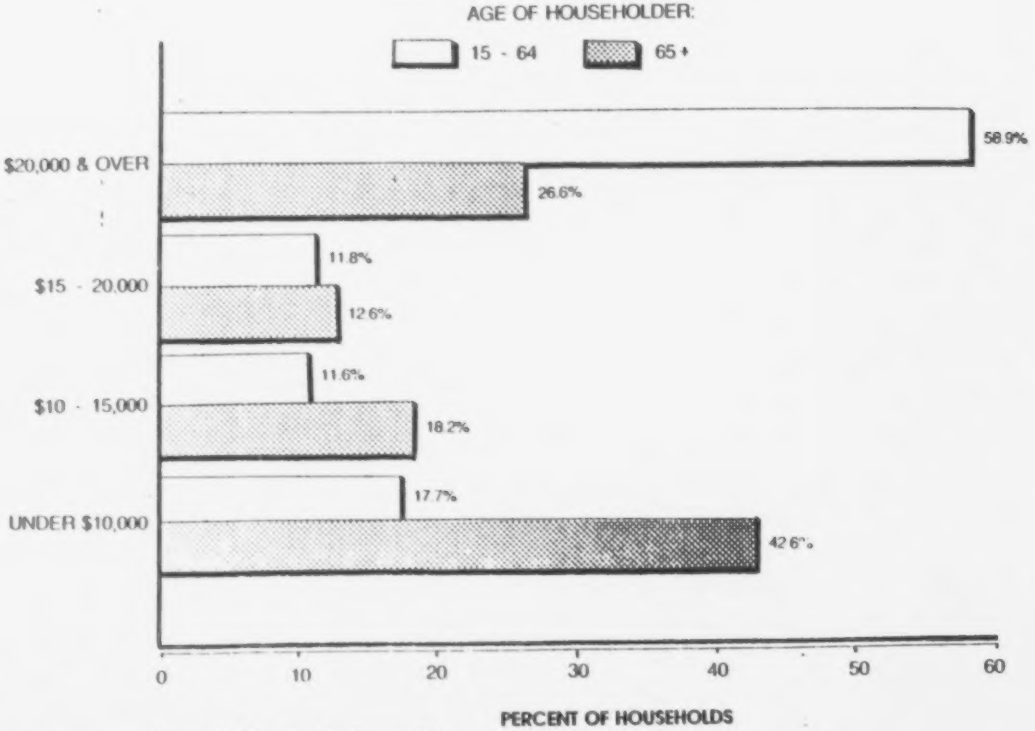
1983 MEDIAN HOUSEHOLD INCOME: ELDERLY VS. NON-ELDERLY



Source: U.S. Bureau of the Census. 1984

Chart 3

1983 HOUSEHOLD INCOME: ELDERLY vs. NON-ELDERLY



Source: U.S. Bureau of the Census, 1984

the 85-95% range.) For older minority and those of advanced years poverty exceeds 40%.

It would be tragically ironic if our progress to date in Social Security, pension and retirement policy which was intended to improve the income situation of America's elderly was used as rationale or lever for their undoing.

While we're on the subject of the economic condition of older persons, a second area of concern on our part is the increasing cost of health care borne by older persons. Since the late 70's a growing share of older persons's income has been taken up by the cost of health care. Amounts spent by Medicare beneficiaries for premiums, deductibles, coinsurance, and excess charges by physicians rise each and every year at rates well in excess of general inflation. In fact, these charges along with out-ofpocket costs for nursing home care, drugs, and the many other services for which Medicare does not pay, now consume, as a percent of older persons income, more than before the beginning of Medicare. (Chart 4) And this is occurring despite the fact that both the hospital length of stay and visits to physicians per capita by older persons have been declining for a number of years.

Moreover in the past several years, older Americans have borne the burden of reductions in benefits. The net effect of these increases and rising health care costs has meant that in the preceeding five years, the hospital deductible has doubled; the Physician deductible almost doubled; coinsurance for physician care doubled and excess charges from physicians tripled.

CHART 4

ANNUAL HEALTH CARE PAYMENTS MADE BY THE AGED

	Per Aged Person	Payments as a Percent of Income
1966 (Pre-Medicare)	$300	15%
1977	$698	12%
1981	$1198	14%
1984	$1550	15%
1989	$2208	16%
1993	$2892	17%
2000	$4637	19%

Source: Health Care Financing Administration; American Association of Retired Persons

(Part of these increases would have occurred in any case, while part is due to program reductions made in the last 4 years.)

In addition:

- --Almost $100 billion in benefits will have been saved in Social Security by 1989 (Under the Omnibus Budget Reconciliation Act of 1981 and the Social Security Amendments of 1983, including $40 billion from the COLA delay; $26 billion from "recapture of benefits" through taxation; minimum benefit, lump sum death benefit, student benefit, etc.)
- --Several billion more in reductions in housing, nutrition, energy assistance, and other social services benefitting the neediest among the elderly.

And--while no price tag can be applied to it--the constant war of attrition on their benefits has left many older persons literally scared of what stories the evening news or morning papers may bring. Unfortunately, what passes as the normal Washington game of trial balloons and planned leaks, looks frighteningly real to those living beyond the Potomac.

In short, there have been significant reductions in benefit levels. Some were probably inevitable given Social Security's financing problems. But, nonetheless, they are all real and remain on the balance sheets with which we begin this year.

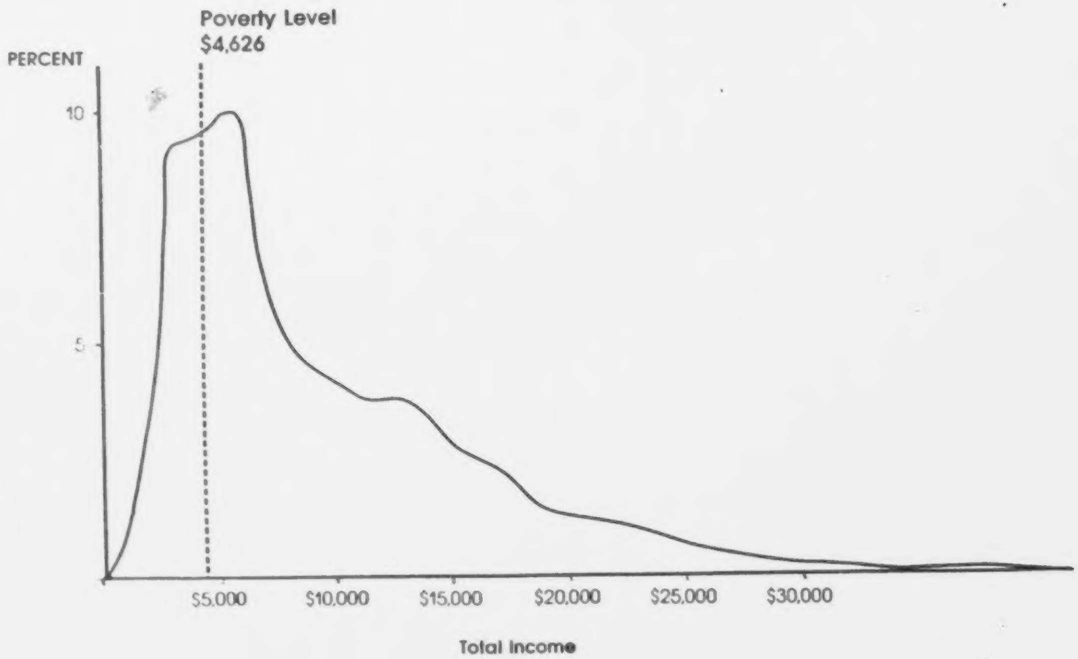
And, the Administration's FY 86 Budget proposals would only heap further burdens on those who have already borne earlier cuts, while barely making a dent in the deficit.

One area on which we at AARP are firm in our conviction is the value and importance of the concept of social insurance. We hear much about the so-called "middle class" entitlements--as if that were an indictment. But, who really benefits most from Social Security and Medicare: not the wealthy, they draw only a fraction of their income from Social Security. As illustrated in chart 5, aged Social Security's beneficiaries are concentrated in the lower end of the income scale. (Moreover, the more affluent tend to have better health.) Those who benefit most from these so-called "middle class entitlements" are the poorest and most vulnerable among us, more often than not a widow, living alone and over 70 whose primary, if not sole income is Social Security. By design, Social Security provides relatively more to those with less. Correspondingly, by the nature of its program benefits, Medicare does likewise. Moreover, when we take into account the taxes paid by middle and upper income older persons the overall progressivity of public policy toward the aged is even further enhanced.

Preserving the concept of social insurance is central to protecting older Americans today and. The fact that all Americans upon reaching retirement have a right to these basic programs is part of the genius behind them. None of us knows were fate anents may take us on the road of life, but all are assured of a decent floor on ito stand and this must be kept so. Proposals to means tests, by one manner or

Chart 5

DISTRIBUTION OF AGE 65+ SOCIAL SECURITY BENEFICIARIES BY TOTAL MONEY INCOME 1982



Source: Grad, Susan *Income of the Population 55 and Over, 1982*. DHHS, SSA, March 1984, Table 13 another may be well motivated, but in our view they are a short-sighted response and no solution to Medicare's problems. Not only would they erode the social insurance concept--thereby undermining support of current and future workers--but, they are merely a further cost-shift, not a cost-constraint. (And, frankly, it can't raise much money either because there simply aren't that many wealthy elderly.) Cost-shifting is not a solution, it simply delays the day of reckoning by changing the address on the bill.

While cuts in Social Security would reduce the deficit given its position in the unified budget, the Social Security trust funds are solvent. As the President himself has stated, Social Security is not adding to the deficit. To make further cuts in this program is not only unnecessary but would have its harshest impact on low income beneficiaries.

In light of this dependency on Social Security, what would be the impact of two COLA-cut proposals which areuently advanced. Studies by DRI (Data Resources, Inc) for AARP, demonstrate the effects of both a CPI minus 3 and a one year COLA freeze, as follows:

> CPI-3: For the average retiree, the CPI-3 proposal would result in a benefit loss of $1,016 over three years; $1,756 for a couple over the same period. If the CPI-3 proposal were to become effective with the January 1986 Social Security COLA, an additional 500,000 elderly persons would be thrust into poverty by 1986; over 2.3 million more elderly persons would

be pushed into poverty by 1990.

One Year COLA Freeze: The average retired worker would lose $899 in benefits over three years; $1,600 for a couple over the same period. If the freeze proposal were to become effective with the January 1986 Social Security COLA, an additional 553,000 elderly persons would be thrust into poverty by 1986; 547,000 would fall below the poverty level by 1990.

As you can gather, we have, by necessity, two views--a desire to reduce the deficit and a desire to protect the beneficiary. But, these two seemingly divergent objectives are not in our view mutually exclusive. To bridge them requires a finely tuned package of spending and revenue provisions.

At the same, we are realistic--we know that with as large a portion of the budget directed at older persons, there will be some pain in any deficit reduction package. But in evaluating any package we will look--as we have in the past--at whether on balance the package is both fair and effective:

To be fair, the package must recognize the sacrifices made in previous budget reductions by various groups including the elderly. And since no solution will be painless how this pain is distributed.

To be effective, it must address the two primary forces now driving up the deficit: the rapid increase in defense spending; and the huge drop in tax revenues precipitated by the excesses of the 1981 tax cut (for which there was bipartisan responsibility).

Since 1981, already enacted changes in spending and tax laws have dramatically changed the shape of federal fiscal policy. Any responsible effort to reduce the deficit must recognize the effects of Congressional and Administration action over the past few years. On the tax side, as Chart 6 demonstrates, the effect of Congressional action on revenues has increased the deficit (FY82-90) by well over a trillion dollars.

On the spending side, however, cuts in domestic programs reduced the cumulative deficits from FY 82 through FY 90 by over half a trillion dollars. But, another $400 billion was added back in for defense spending.

Finally, the effect of all this red ink and rising interest costs have added yet another $400 billion to the cumulative deficits.

As chart 7 shows, the mix of federal spending has been dramatically changed in the course of just the last four fiscal years (FY 82-85). Both as a percent of GNP and as a share of outlays, spending for national defesnse and interest costs are up, while spending for all domestic programs including the so-called "uncontrollable entitlements", is down. (Within the entitlement area, the Medicare program continues to grow though it is beginning to show some signs of slowing.

Deficit reduction which is limited only to the spending side of the ledger is neither fair nor can it be effective. In reality, the federal government distributes benefits and

Chart 6

INCREASE IN THE DEFICIT ATTRIBUTABLE TO CONGRESSIONAL POLICY ACTION

(Fiscal Years; Billions of Dollars)

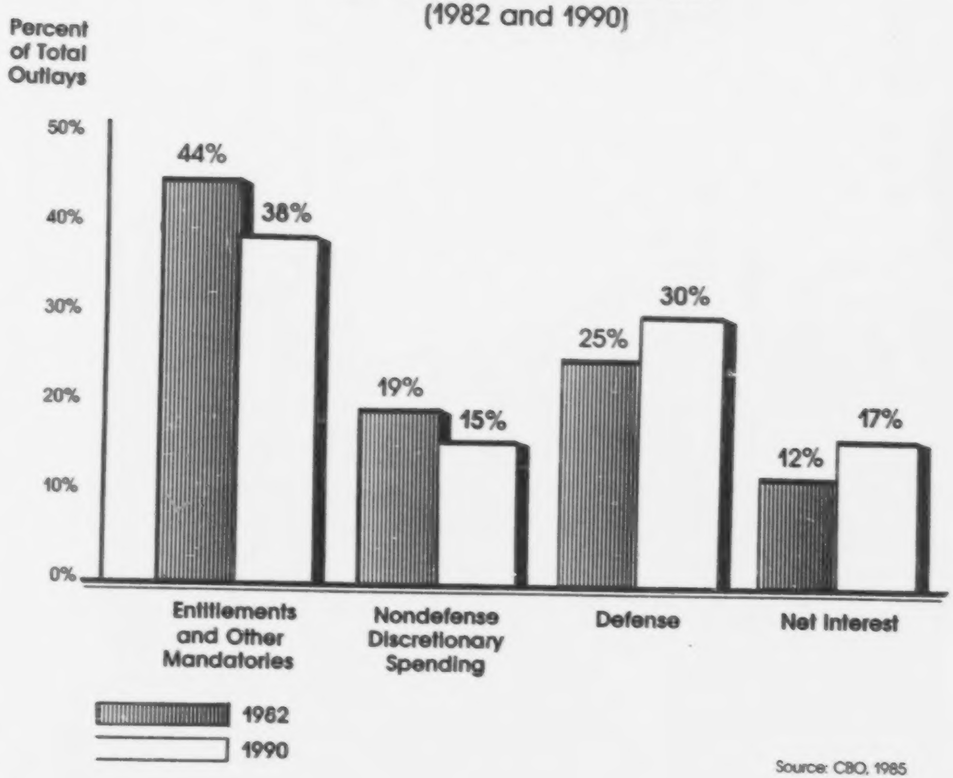
	1982	1983	1984	1985	1986	1987	1988	1989	1990	TOTAL
Legislative Changes										
Tax reductions	-41	-75	-99	-111	-130	-149	-162	-186	-228	–1181
Defense spending increases	-3	-16	-23	-35	-41	-53	-65	-79	-95	– 410
Nondefense spending cuts	40	48	50	38	63	69	73	82	88	+ 551
Effect of legislative actions on interest costs	a/	-3	-10	-21	-35	-50	-69	-93	-123	– 404
Total changes	-5	-45	-81	-129	-143	-183	-223	-276	-359	–1444

SOURCE: Congressional Budget Office.

CHART 7

COMPOSITION OF OUTLAYS IN THE FEDERAL BUDGET

(1982 and 1990)



Source: CBO, 1985

subsidies on both sides of the ledger. Revenues foregone due to tax expenditures, have doubled in the past five years. If the Administration and Congressional leaders are going to ask for sacrifice from those who draw subsidies from the spending side of the budget, then too, sacrifice must be expected from those--corporate and indiviudal--who draw subsidies on the tax side. While many provisions were placed in the tax code for sound or economic reasons, others were and remain eggregrous. In addition some provisions, when enacted, were premised on assumptions which no longer hold. For example, in 1981 part of the rationale for the provisions of the accelerated cost recovery system and the investment tax credit was high, double digit rates of inflation. ACRS is estimated at $ 18 B in FY 86 and ITC at $32 B by 1990 if left unchanged they will grow to $14 B and $41 B respectively. These provisions are now excessible and should be curtailed in light of lower anticipated inflation. If this Congress decides to ask older Americans to give up their inflation protection, then it cannot ignore provisions which provide even greater inflation protection on the tax sides.

In the Medicare area savings can and should be achieved, but not by shifting costs to taxpayers or beneficiaries. Rather, we should promote federal and state efforts to reduce the rate of growth in health care throughout the system. This can not only help reduce the deficit--both on the spending and revenue sides--but also keep inflation down.

In closing, let me say that we appreciate the opportunity to join you today. All Americans regardless of age have a stake in finding a solution to the deficit. Ultimately, we hope that we can work together to find a solution that none of us will like but all of us can support, and which the public will review as both fair and balanced.

Chairman DOMENICI. Senator Chiles, I have inquired of Mr. Trowbridge at the beginning. If you would like to inquire at this moment, I yield to you.

SOCIAL SECURITY COLA'S SUPPORTED IF REDUCTION PACKAGE IS FAIR

Senator CHILES. Mr. Brickfield, I understand it is your position that you would consider the possibility of Social Security COLA's but only if such action is part of a package in which everyone is asked to make an appropriate share of the sacrifice.

My understanding is that your position is everything should be on the table, and that includes revenues.

Mr. BRICKFIELD. Yes.

Senator CHILES. I believe you have also said you believe your members would only be willing to sacrifice on the cost-of-living adjustments if the package was big enough to really get the deficit under control.

I wonder—and I do not want to misstate your position, but I wonder if you would clarify it, or let me know if I am hearing you right.

Mr. BRICKFIELD. I think that is a fair statement, Senator. But so that I am not misinterpreted, we oppose cuts in Social Security. We do not want to see COLA's frozen.

However, if you are looking at the reality of the situation—and there is a package before the Congress, and we have to swallow very, very hard—then we would consider a freeze provided, however, it is fair and balanced, and it includes reductions in the rate of spending, in defense, but also increases on the revenue side of the budget. And third, we also truly believe that health care costs are really running away. I mean, hospital costs are out of sight, hospitals are not competitive, and doctors' fees are mounting. So we think that a great deal of savings, perhaps $50 billion over 4 or 5 years, can be saved in the area of health care costs, and we would support that.

Senator CHILES. Mr. Koelemij, I am glad to see you again this year. And I am also glad, and I want to congratulate you on your position. We are proud in Florida that you are head of the National Association of Home Builders.

I am glad to see that, again this year, deficit reduction is a primary concern of the Home Builders. I think we on this committee and in the Congress appreciate the support that you have given us for an across-the-board freeze that includes defense spending.

I believe that if we are going to be serious about deficit reduction, every part of the budget has to be on the table, and the package must get the job done right so interest rates can actually come down.

It is interesting, Cy. I have been before some of the senior citizen groups in Florida, and I have been asking them a question. Would they agree to allow the COLA's to be put on the table and a freeze on Social Security. And I again put the proposition—if we had a package that shared the pain and sort of treated all areas fairly, and if we could assure them that that package would do the job and get interest rates down and keep inflation from starting again. And when I asked for a show of hands, it is well over 50 percent, and it is generally 65 or 70 percent of the people that are saying they are willing to do it.

But then, generally, somebody would get up and say we want to reinforce what you are saying; everything is going to be on the table, and that you are talking about getting a package that you are going—we are not going to have it this year, and then something is going to break out, and we are the ones that are caught.

I find that happens, really, when I go before a group of small businessmen, or whether I go before whoever your group. Of course, people have different ideas of what sharing the pain means, and that is one of the things we could get into, I guess.

And yesterday, Alan Greenspan told us that long-term interest rates could fall by at least 2 percent if serious deficit reduction were undertaken.

I am concerned, however, that a deficit package that focuses on spending alone may not be enough to make a serious dent in the deficit. If the deficit is still approaching $150 billion to $170 billion after a spending package has been put together, would you or would Home Builders support some kind of revenue measures in order to make a more meaningful reduction in the deficit?

TAX CONSIDERATION SHOULD BE BROAD BASED

Mr. Koelemij. Senator, we realize that taxes are kind of on the table, but on the other hand, we have not given it any specific policy consideration. We feel that first, the effort should be in the cutting of spending, that that would have the greatest potential impact on ultimately bringing the interest rates down.

The concern we have is that in the past few attempts to raise taxes, that a great share of that burden was accomplished by the closing of so-called loopholes. And if I look in the wings, and I look at Treasury tax proposal and then some of the last remaining tax preferences for housing are being so-called closed as loopholes, it would be devastating to housing. So we feel that any tax consideration should be broad based. It should be whatever form it might take, but it should not pinpoint to an industry all by itself or for too large a share, but should be broad based. There are many ways to do that—a surtax, or an energy tax, or whatever it might be.

Senator Chiles. You do not exclude some revenue if, after we have made the spending cuts, it is necessary to again get the package down to where we know it will do the job.

Mr. Koelemij. We do not exclude it, and we are looking at the tax proposals that are in the wings. And even though they are so-called revenue neutral, they have a very heavy burden on some industries, and especially the real estate industry.

Senator Chiles. Dr. Carlson, can you give me some response from the realtors on that? And again, I want to compliment the realtors, also. Your group has certainly been at the forefront of this in the past. I compliment you talking about an across-the-board spending freeze.

CUT OUT LOWER PRIORITY PROGRAMS

Dr. Carlson. Yes, sir, and we tried to do our part to identify spending programs where our members and their customers are the beneficiaries and help cut those out of the HUD budget during the last 4 years. So we feel that the sacrifice has to take place both across the board and individually and we have tried to do our share.

We do think you have a unique opportunity, though it is politically painful, to kind of audit the spending programs and cut out lower priority ones. And I am afraid there has not been that constraint, that movement, to really go through and cull out those lower priority programs. So we would hate to see this opportunity missed.

Senator CHILES. What do you think we did in 1981?

Dr. CARLSON. I was not overly impressed with your spending reductions in that year. I was impressed with your tax cuts, however.

Senator CHILES. Well, when you look at those charts, you see that we cut some $500 billion off spending.

Dr. CARLSON. I would have to look at those charts. As a former Assistant Director of OMB, I would be a little suspicious of those numbers, but I would be glad to go through them.

Clearly, your tax cuts, and primarily tax cuts for consumption, was the big orientation of 1981, as opposed to spending reductions, although there was some spending reduction.

I would hope that you would use this opportunity, even though it is politically painful, and it is painful for people who may run for office and have constituents who are going to be upset in 1986 and 1988, to take this opportunity to kind of weed out the lower priority programs.

If you did then come for revenue increases, we would support them if they were not anti-investment, antihomeownership, and antisavings. We think that growth is an important objective.

HARD TO CUT SOCIAL SECURITY WITHOUT LOOKING AT TAX EXPENDITURES

Senator CHILES. You said worked for OMB before. I do not know whether you have ever run for office before, but I can tell you, it is a little bit hard to go and tell somebody you are going to cut their social security COLA, but you are not going to look at tax and tax expenditures that allow some people to pay no taxes, and allow some corporations to pay no taxes. You are saying, "We are just going to cull out a few unnecessary spending programs here." Most people do not exactly——

Dr. CARLSON. I think, Senator, you have to look at the incidence of the tax. If you are looking at corporations, you have to look at the workers in the corporations, the investors in the corporations, and the consumers, and see where the incidence of that tax is. Corporations do not pay taxes.

Senator CHILES. Well, if you have a law that says a corporation can pay up to a certain tax, and if a small or medium corporation is paying under that and paying average tax, how the hell do we get out of saying that the largest corporations that are making the most profit pay zero dollars to their government? I cannot find a way—I wish you could tell me how to rationalize that, and I can use that when I go and try to talk to those constituency groups.

Dr. **Carlson**. I think the strongest argument is to look for the incidence of the tax on people, and that is where it counts, and see if there is a fairness. What bothers me is that the debate on revenue increases has not even focused on growth, on investment for growth, and consequently, many of the proposals are anti-investment and antisavings and antihomeownership. I think that is unfortunate. And I understand the political reality. We always look at fairness, and we do not look at growth. But the bigger economic pie is going to make everybody better off, potentially.

Senator **Chiles**. I certainly agree with that.

Mr. Trowbridge.

SPENDING SIDE SHOULD BE PRIORITY TRACK

Mr. **Trowbridge**. Senator, I think we have to start with this effort at deficit reduction, concentrating on the spending side, and that is clearly what this committee is doing, and we applaud it. That track ought to be the priority track. It should, and I think can, come up with $50 billion of reduction in the deficit in fiscal 1986, if it includes the defense and social security elements we have talked about here.

I think that the questions of revenue fairness are obviously going to come up in the subsequent discussions on tax reform, some of which have been put forward by the Treasury and will obviously be amended within the next 3 to 6 months as the Congress debates those final recommendations of the administration.

I would hope that we would concentrate here on the spending side, do everything possible—and I think it is possible to make the impact in 1986.

SPENDING PLAN NOT POSSIBLE WITHOUT SOME REVENUES

Senator **Chiles**. Well, here is the proposition I want to put to you. If more is possible on the spending side, if we can talk about revenues, should we be looking at that? Every time we take something off the table, then we are in trouble. When the President says we take defense off the table, we are in trouble, because other people say, "I ain't going to cut my program." When you take Social Security off the table, we are in trouble, because people say, "Wait a minute. I am not going to allow you to cut other retirement benefits and pension benefits and veterans' benefits, and allow Social Security to be exempt."

And when you say revenues are off the table, and we are not even going to look at spending, you hear Mr. Brickfield, and you hear other groups say, "Wait a minute. Do not look at our proposals if you are not going to look at revenue."

So I understand what you are saying. I understand the fear out there. Maybe what we have to be talking about is the revenues coming after the spending cuts. Maybe they do not go into effect the first year. I am not trying to reduce what we are trying to do on the spending side. I think what David Stockman said is basically right. Let us quit talking about $50 billion in 1 year. That is what we are talking about now, because we do not want to look at the second year and the third year. When you talk about a domestic freeze, it is easy to talk about that 1 year, but the proposition is you have got to go from 5 percent to 2 percent, and if you have got to go $150 billion over 3 years, that the third year needs to look at about $100 billion or less.

Why? As we heard from Mr. Volcker, as we heard from our Director of CBO, Dr. Penner, if you do not, your interest growth itself keeps that deficit growing.

Now, we have the President's budget, and my gosh, he certainly took on some programs; he made some drastic cuts. He has a deficit of $170 billion at the end of the third year. One reason his budget will not go through is because at the end of all that pain, it is still there. So the proposition I am really trying to lay out here is to get the job done. There is no way you can do it without some revenues. And if that is the proposition, are we willing to look at revenues?

BUILD ON PRESIDENT'S PROGRAM WITH ACROSS-THE BOARD SHARING

Mr. TROWBRIDGE. Clearly, if we are at a point where the total efforts of this Congress and the administration focusing on the spending side are not enough to bring the deficit down over a 3-year period, the next issue before the Congress is revenue.

But I think we would be remiss to take our eye off that principal target. I believe, Senator, that the fiscal 1986, 1987 and 1988 kinds of projections of $53 billion——

Senator CHILES. I understand, but if the target is smaller after you have excluded revenues, can we look at the target?

Mr. TROWBRIDGE. As we calculate the impact of a combination of the President's budget proposals plus a defense freeze and Social Security-COLA freeze, the 3 years, 1986, 1987 and 1988, could bring total savings estimates and outlays of $53 billion, $99 billion and $139 billion, respectively. Those are the kinds of reductions which I think would make an enormous impact on the deficit and on the confidence that should be restored by action on the spending side and getting those deficits——

Senator CHILES. What are you talking about in defense, 0-3-3, outlays, budget authority, or what?

Mr. TROWBRIDGE. Outlay reductions of 6 and 19 and 36 billion in the 3 fiscal years.

Chairman DOMENICI. How much?

Mr. TROWBRIDGE. 6.0, 19.1, and 36.6 in the 3 fiscal years, with 4.5 percent inflation included.

Chairman DOMENICI. Now, that is off the President's line.

Senator CHILES. Is that off the President's line?

Mr. TROWBRIDGE. That is off the CBO baseline, the 1985 baseline.

Chairman DOMENICI. Well, it could be. And then you take all of the President's domestic cuts and the freeze in Social Security.

Senator CHILES. Oh, you are taking all the President's domestic cuts?

Chairman DOMENICI. Yes.

Mr. TROWBRIDGE. As presented, yes, sir.

Senator CHILES. It ain't going to fly. That is what I am trying to tell you. Do you really think this Congress is going to cut out Amtrak, small business loans, 35 percent reduction in all rural programs? We are talking now about a farm bill that is going to spend more money. I mean, the President has put that down on paper because he exempted defense. If he had to put all those cuts in there, his cut numbers would not look very high.

Mr. **Trowbridge**. Our urging to the committee is that it build upon the President's program, add defense and Social Security so that you do get a sharing of the burden across the board, and go for the bigger numbers.

Chairman **Domenici**. Mr. Koelemij?

$51 BILLION REDUCTION SUPPORTED WITHOUT REVENUE RAISING

Mr. **Koelemij**. Yes, Senator. In answer to Senator Chiles' further question, I would like to observe that in the past, we have come before this committee and said that we are willing to support spending cuts, and we are willing to also consider revenue-raising steps to ultimately accomplish the budget deficit reduction.

In the past, the attention started to shift to revenue raising, and that is why we feel that at this time, we should support, in our approach and in our recommendations to the committee, the deficit reduction by cutting the budget $51 billion.

If in your wisdom it is best to go higher and to cut it more, then we would consider revenue raising to add to that cutting of that deficit, because even in the President's best explanation of Mr. Stockman's proposal, we will still wind up with a $140 billion deficit in 1988. And that is still high. And as long as that tax raising is broad based, we would support it.

Chairman **Domenici**. Go ahead, Dr. Carlson.

FIXATION OF CONGRESS ON TAX SIDE IS FAIRNESS

Dr. **Carlson**. There is a problem, just on the spending side, to have priorities. On the tax side, the fixation of the Congress is fairness and going after corporations or other areas, which tend to be more investment oriented than consumption oriented. So the fixation of the Congress, on the revenue side, is on anti-investment, antigrowth, and that is unfortunate.

Surely, if you identified some changes in taxation that was not anti-investment, antisavings, antihome ownership, antigrowth, people would feel a heck of a lot more comfortable than the conversations that have taken place.

Chairman **Domenici**. Mr. Brickfield, did you want to comment?

LOOK AT ACCELERATED COST SAVINGS SYSTEM

Mr. **Brickfield**. Well, yes. We have short memories, Senator. Social Security has been cut $100 billion during the last 3 years to carry out through this decade. I just heard the gentleman on my right saying we were kind of thinking about raising revenue in the past few years. That is not so, and you can look at this chart.

And this is a CBO chart, not AARP's chart. But I still come back to the fairness issue. You ought to take a look at the accelerated cost savings system. It was put into effect a few years ago because we had double-digit inflation. Those conditions no longer hold. You ought to take a look at that. That is a subsidy, that is a benefit. Those are the things you should look at. I do not say an across-the-board, but you certainly should be selective on the revenue side.

Thank you.

Chairman **Domenici**. I do not know if Senator Gorton has any questions. Senator Kasten, do you want to put any questions in the record? Slade has some inquiries.

Senator **Kasten**. Mr. Chairman, thank you very much, and Senator Gorton, if you would yield for just a minute. Mr. Chairman, I would like to submit two questions to the witnesses for the record. I am not going to be able to stay for the rest of the hearing, but I would like to put two questions to the panel, and have them respond for the record. I ask for each of the gentlemen to respond.

Chairman **Domenici**. If the panel would answer those as quickly as possible.[1]

Senator **Kasten**. Mr. Chairman, thank you.

ENGLAND RAISED INTEREST RATES AND THE POUND DROPPED

Chairman **Domenici**. Before I yield to Senator Gorton, let me say, Dr. Carlson, that I have a couple of things on my mind that really bother me. I will then get to the dilemma of the proposal that you make with reference to tax increases and the implication that has been going around that we ought to readjust the corporate tax structure as part of this package. I think we are really in a box, for a reason I will explain in a moment.

But Dr. Carlson, England tried to increase the value of the pound, or stem its downward flow by increasing interest rates. They did that through their equivalent of our central bank. They raised interest rates 3 or 4 percent—I think it was 4, but I do not remember. And the pound dropped instead of going up.

Why did that happen?

Dr. **Carlson**. In the first place, the basic productivity of investments in one country versus another, given its growth and circumstances, is important. It is not only the interest rate attraction into the United States. It is also the safety and soundness of investments in this country. And consequently, I was not surprised that they could not, with the means that they have, stem the changes in the value of the dollar in relationship to the value of the pound. These changes are too fundamental that are taking place across countries for a central bank to intervene very successfully, and it was wise for Chairman Volcker to recognize that in his recent testimony.

FIX TAX REFORM PROPOSAL

Chairman **Domenici**. Well, let me tell the four of you the dilemma that I think we are in. I understand Senator Chiles. He was talking about a deficit package, but followed at a later date by tax increases. And I understand that very clearly, as he explains it.

When we talk about such things as the corporations that are not paying taxes, I am sure everybody knows that offends everyone, and I accept your explanation, but I do not think it is going to last very long around here. And I am not so sure it should.

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[1] See p. 592.

On the other hand, here is where the President has put that situation—I want this especially to receive a comment from you, Mr. Brickfield. What the President has done with the inequities in the corporate structure and any other inequities that you might find as you look at the American taxpayers, is to say, "Let us fix that." But he is also saying when we fix it, let us take the taxes we are going to collect from those who are not paying a fair share—and put it back into the overall tax structure so that we can lower the taxes of the average taxpayer.

Now, we have got a real problem here. There is a corporate minimum tax in the tax reform package. But the revenues received from the reform do not go to pay this deficit; they go to reduce taxpayers' taxes. And if you take all those reforms out of consideration, then clearly, the marginal rates in the package have got to go up, or else you really lose taxes in that package rather than come out tax-neutral.

So I think we are in a bit of a hiatus there, because to the extent that we want to protect some of those, as you suggest, we do make it almost impossible to lower the marginal rates later in a tax reform package. They are now saying we may have a package before the year is out. That may be overly optimistic.

I do not want you to agree, and I am not asking you to agree or disagree. I am merely asking, do you understand the problem we have got?

Mr. Brickfield. I understand the problem, and I know we have got to look at the marginal rates. But I think we have got to look, Senator, in the near term and in the long term. And I am talking to 1990. And in this crucial time there has to be some give on the revenue side. And I would also say there has to be a minimum corporation income tax.

LOOK AT REASONS FOR ACCELERATED COST RECOVERY ACT

I say also that you should look at alcohol and cigarette taxes, because they are keyed into the Nation's health. They are being reduced, if my percentages are correct, it is now at 16 percent. It used to be at 8. It is going to go back to 8 percent. I would say use that, make use of that.

I would also take a look, as I said earlier, at the reasons for that accelerated cost recovery system and the reasons for it when it was enacted into law. And that was because of tremendously high inflation, tremendously high inflation; the investment tax credit as well. Those conditions no longer hold.

So you ought to take a look at the ACRS. It would not be a tax increase, if you look at it the way we look at it. I suggest suspending that subsidy for a year; call it a freeze, if you like, on the revenue side. It is a benefit to business. If you are going to freeze us on the Social Security side, then you should in fairness think and look at and consider the subsidies on the revenue side.

Chairman Domenici. Let us have just one more comment, and then I will yield to Senator Gorton.

Yes, Dr. Carlson?

CONSIDER TAX ON PERSONAL INCOME TAXES

Dr. CARLSON. I think if you are thinking of the revenue side, if you want to have full fairness and growth, you have got to look at a tax on personal income taxes and not kid yourself. You may disguise it by running it through a corporation that comes back on workers, or comes back to the higher price and higher cost of doing business where the consumer pays for it. But that is really what you are talking about, and run your fairness off of what the impact is on individuals. The growth is not in the dialog.

If you look at the statistics—and everybody has been touting the fact that investment grew during the last few years—if you look at investment on structure, which we are most short of at the present time, except in a few areas, we actually have less as a percent of GNP in this recovery in comparison with all other recoveries.

So we have been anti-investment, we are anti-investment in our public policies now, and the dialogue is anti-investment on the tax side. And somehow, we have to get away from that mental set, or you are going to have less of an income to spread around to people in the future than we have now, as in our statement, $2 trillion less, or $20,000 per family, in the next 10 years.

Chairman DOMENICI. Senator Gorton?

TREAT TAX PROPOSALS WITH CAUTION

Senator GORTON. Mr. Brickfield, I want to follow up on the very comment which the chairman made. I believe that your organization and your members will end up being very strong supporters of a tax reform proposal not too dissimilar from what Donald Regan set out in November. I am convinced of that. I found it to be very attractive. All of us can quarrel with it. But the dynamics of that proposal were very, very significant.

I believe as a consequence, that you should treat with great caution and great care, in spite of that chart, any tax proposals at this time which are a part or are almost certain to be a part of an overall tax reform proposal. If we take them out of the context of tax reform—and there are many of the kinds of examples that you set out with which I would agree, and have in the past—and put them into the context of deficit reduction, I am convinced that we can easily kiss tax reform goodbye for a decade or for two decades. I am convinced we have a window of opportunity which has been created for us this year that we are going to need, for tax reform.

TOBACCO TAX AND TAX INDEXING

Now, that does not mean that there are no ways in which to increase revenue, and a couple of these people have mentioned them. Those ways may well be exactly what you have said, in tobacco, or in liquor, or in some other kind of excise tax, as opposed to things we have thought of as loopholes. I want you very carefully to consider that, because I think you may get a little bit of deficit reduction and pay for it by not having any tax reform.

But for these gentlemen here, it seems to me there are at least two potential revenue producers that appear to go hand-in-hand. Either can arguably be stated not to be tax increases, or to be so much a pattern of the kind of fairness Mr. Brickfield is talking about when we are asking the people he represents to forgo cost-of-living adjustments for a year, or as some of you testify, for more than a year.

So I ask you first, not the general question Senator Chiles did, about putting taxes into it, but do you really consider that if we consider keeping the tobacco tax at 16 cents, rather than letting it drop to 8 cents, that that is a tax increase that you would oppose, as we work toward this goal? Well, you are sort of shaking your heads no; the record can state that. But the next one is a little bit harder. If, in fact, we freeze cost-of-living adjustments at zero for a year, is it not just and equitable to freeze the basic tax indexing proposal for a year, to put those parallel to one another, without really calling that a tax increase, but making it contribute to deficit reduction? I think it is much more than $51 billion that we are going to need to get off this deficit in the first year, to get where we want to go, as long as we have these major spending cuts at the same time. That part of the question, at least, is for the three of you who represent the business community, although I will be happy to have Mr. Brickfield comment on it as well.

Mr. TROWBRIDGE. Senator, I think there is a certain symmetry to what you suggest there. The indexing provisions which I think take place in 1985-86——

Senator GORTON. Well, we already get them this year, so we are talking about next year.

FOCUS ON SPENDING REDUCTIONS NOT TAX ISSUES

Mr. TROWBRIDGE [continuing]. That were in the 1981 Tax Act—clearly, were put in in order to meet an inflationary factor that was raging at the time. I think that factor is less, clearly less, now. I would think that would be part of the discussion within the tax reform area that we have yet to go through. But I very much support your earlier point that to mix in tax issues at this point on the deficit is going to take our eye off the main objective, which is to find those spending reductions where a real impact on the deficit can be made in these 3 fiscal years we have been considering.

Dr. CARLSON. I would agree with you on the tobacco tax continuing, and on tax indexing. Some of us in the past have proposed CPI minus 2 or CPI minus 3. The CPI overstates inflation anyway, so using it results in a redistribution of income to the extent it is above the actual cost of living. The overstatement has been 1 to 2 percentage points over the last several years and as much as 3 percentage points at some times, even though with the improved CPI, it is still about 1 percentage point. So at least the adjustment for that should take place in the future, if you do not go to what the practices are in the private sector. The best practices in the private sector are about equivalent to CPI minus 2 under the current conditions.

Senator GORTON. Mr. Koelemij?

Mr. KOELEMIJ. Mr. Chairman basically, I agree with what Mr. Carlson just said, so I do not have to repeat the whole statement.

Senator GORTON. Mr. Brickfield, I would be happy to have you respond.

DO SOMETHING WITH BOTH EXPENDITURES AND REVENUES

Mr. **Brickfield.** OK, I will be short, Senator.

We think we can do a bit of both, on the expenditure and the revenue side at the same time, and I would cite an example. That was the Social Security Reform Act of less than 2 years ago, where the bottom line was to cut benefits and increase the tax rate. Both in the same package.

We have been looking at the Treasury proposal. We have a problem, Senator, if you come out with a revenue-neutral bill. We ask, where will you be reducing the deficit that everybody is talking about?

Chairman **Domenici.** Well, let me just suggest—that there appears to be a growing difference of opinion. The President assumes that the last election said, "Reduce the deficit" but that it also said, "Do not raise taxes." So, when you say, how are you reducing——

Mr. **Brickfield.** Senator, he also said he would not stand still for any reduction in Social Security benefits.

DECISIONS ON BUDGET CUTS VERY DIFFICULT

Chairman **Domenici.** Oh, I understand. I am assuming that those who believe literally that that was the election want to reduce the deficit—and I will finish and make my point—by leaving your cost-of-living allowance alone and reduce the deficit all on the expenditure side. I am merely saying that I agree with you. You cannot get there without the savings that come from a 1-year cost-of-living freeze, without more savings in defense, not because it is politically impossible to get the rest of that litany—to tell you the truth, there are some items in the litany of programs that are not very good policy. I mean, you cannot do all of them, not only because some people say we do not have the courage because there is an election coming. I am extremely courageous. I just got elected. Six years is an awful long time. But I have to look at reality—can you really do away in toto with operating grants for mass transit across America, and can you do away with it right now, all of it? That is in the budget. That is $1.7 billion savings. I mean, if you are talking about some dislocations, I do not like the dislocations in mining, which I have complained about to everybody around. My State has lost 6,000 or 7,000 miners in the last few years. But it would be rather enormous to take $1.7 billion out of operating maintenance for mass transit right now. There are those types of programs you cannot get in the package. I do not know how much you can do with ExIm bank in one shot. I do not know how much you can do in terms of the farmers in one shot.

So it is difficult; there is not any question about it. And frankly, I appreciate the constructive testimony that you, Mr. Brickfield, have given here in behalf of your membership. Frankly, I am very hopeful that your organization will be followed by those who feel a deep empathy with our seniors, and that you will not take a position until you see what we are able to do.

I would think it would be a very, very tough thing if the position were taken within the next 8 or 9 days, before this committee can work on your ideas, the ideas of Senator Chiles, the ideas of Senator Gorton. Let us see what we can do, because we understand the position as you have given it to us, and I do not have to repeat it, and I thank you very much for it.

To the members of the business community that are here, let me suggest that we need your help. While there is not a homogeneous approach here—the Home Builders seem to have a little different approach than the other two—clearly, we are close to being in accord. I wish we could tell you in advance that we have a plan. I wish you could go out and help us with it, but I think you are helping with the general notion that we have to get something like $50 billion savings in the first year, and a major package over the next 3 years. We are hopeful we can come out of here with something that then you can go out and support at the grassroots level, because the battle is just starting, and it is already very tough.

We are already 30 minutes late for the next distinguished panel, so thank you very much, gentlemen. We are glad you came.

Will you gentleman of the second panel please come forward.

We are sorry we are late. However, we saw all of you present in the audience, and we assume that you would agree that we were not wasting our time or yours. Now we will proceed without any opening statements, unless it is absolutely urgent, to welcome Mr. Robert Kilpatrick, chairman of CIGNA Corp., and also chairman of the Business Task Force of Business Roundtable; Dr. Roger Molander, president of the Roosevelt Center for American Policy; Mr. Donald Platten, chairman of the Executive Committee for Chemical Bank, speaking for the Committee for Economic Development, the CED; and Gov. Richard A. Snelling, chairman of Proposition One.

Let us proceed in the order that I have introduced the witnesses, starting with Mr. Kilpatrick. If you have a prepared statement, it will be made a part of the record, and you can either use it or abbreviate it.

STATEMENT OF ROBERT D. KILPATRICK, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, CIGNA CORP., AND CHAIRMAN, BUSINESS ROUNDTABLE BUDGET TASK FORCE

Mr. **Kilpatrick.** Mr. Chairman, Senator Chiles, Senator Gorton, the Roundtable believes the most crucial economic problem facing the United States is the size and trend of the Federal deficit. Budget deficits, in our opinion, are causing high interest rates, adding to the enormous burden of public debt, threatening the health of the economy, fueling the growing trade deficit, costing jobs and risking a new wave of inflation.

ADMINISTRATION'S BUDGET FALLS SHORT OF GOALS

The Roundtable believes Congress and the administration must move forcefully in the next few months to cut the deficit in fiscal year 1986 and to place the Federal budget firmly and credibly on a path toward balance in the near-term future. Last December, the administration set goals to achieve that objective, to cut the deficit to no more than 4 percent of GNP next year, declining to no more than 2 percent of GNP in fiscal year 1988. Unfortunately, the administration's budget falls short of its own goals.

That budget seeks to hold non-interest outlays in fiscal year 1986 to fiscal year 1985 levels. That itself is a laudable goal and would be a remarkable achievement. By fiscal year 1988, however, deficits in the administration's budget would equal 3 percent of GNP, based on its own economic assumptions, in the fifth year of economic recovery and at full employment.

We, at the Roundtable, are concerned that there is far more upside potential in these deficit projections than downside potential.

The problem with the administration's budget, Mr. Chairman, is not that it would go too far to reduce the deficit. As far as it goes, it still does not go far enough. The problem with the budget is not that it would cut too many programs, but that it would leave virtually intact the two largest programs in the budget; namely, Defense and Social Security.

Cutting the deficit will be painful in the short term for almost everyone in America. Business is willing to take our share. Everything must be on the table. The roundtable believes that the very poor should be spared that pain to the maximum extent possible. We believe further benefit cuts in means-tested programs for the most needy should be avoided. But we believe that all non-means-tested entitlement programs and Defense will have to contribute to deficit reduction efforts, or those efforts surely will fail.

We at the roundtable believe Congress should go beyond the administration's budget in three areas—namely, in Defense, in establishing a spending freeze, and in adopting actual targets for total spending.

POSSIBLE APPROACHES TO CUTTING DEFENSE EXPENDITURES

The roundtable clearly believes in a strong defense. But we also believe that a strong defense presupposes a strong economy. We believe Defense must contribute more to deficit reduction than the administration proposes. While described as a $9-billion cut, proposed defense expenditures appear to us to be a $30-billion increase.

There are several possible approaches to cutting proposed defense expenditures. Three percent real growth for Defense, for example, instead of the 8-percent real growth in the proposed budget, would cut outlays some $64 billion below the levels in the budget and still meet our NATO commitments as I understand them.

And I believe a freeze on Defense budget authority could save $93.5 billion more than the administration's budget. Both of these figures, Mr. Chairman, are over a 3-year period, not a 1-year period. I understand that some argue a freeze would cut too deeply, and others say you should cut programs instead of freezing budget authority, but these are two examples of serious proposals to cut Defense well below the proposed amounts.

FREEZE SOCIAL SECURITY COLA'S

The roundtable does believe the spending freeze concept must be broadened to include cost-of-living adjustments for Social Security recipients. The administration's budget proposes to freeze all other non-means-tested COLAs, and it is necessary and appropriate that this concept be applied to the largest program in the budget as well.

I believe our Social Security recipients will accept that if it is part of a broad-based effort to solve the serious national problem that we have, and a serious effort is made to sell it

ADMINISTRATION'S DEFICIT REDUCTION TARGETS REMAIN VALID

In essence, Mr. Chairman, we believe the targets the administration set for deficit reduction in December 1984 remain valid: Deficits at no more than 4 percent of GNP next year, declining to no more than 2 percent by fiscal year 1988. The proposed budget would not achieve these goals, and Congress needs to adopt a budget which will.

As a necessary first step, it is important for Congress, in our opinion, to adopt specific targets for spending and deficit reduction before it considers individual programs and functions in this year's budget cycle.

Deficit reduction will require hard choices. A freeze is a good beginning. It will lower the base and make further deficit reduction in subsequent years more manageable. But a freeze is not a solution in the long term. It will not redress the basic structural imbalance between Federal spending and Federal revenues. That will require additional cuts and/or program eliminations. The administration's budget proposes a number of such cuts. In addition to the cuts contained in the budget, we believe proposals such as reducing current full COLA adjustments to CPI minus 3 percent, or something along that line, deserve serious consideration.

DEFICIT REDUCTION SHOULD BE NO. 1 PRIORITY

Let me turn just a moment to the question some Senators asked us the last time Business Roundtable CEO's came to see you about the deficit. The question was, what are we willing to give up? Senators, the roundtable companies will do our share. If you put together a package to cut spending $50 billion next year and to reduce the deficit to no more than 2 percent of GNP by fiscal year 1988, I feel certain that you will have roundtable support for your efforts.

Nothing can be accomplished if the deficit becomes a political football. If you delay long, we will be back into another election cycle. The gravity of the problem demands that we put partisanship aside. The roundtable believes both the administration and Congress should make deficit reduction the No. 1 priority and let nothing sidetrack those efforts.

Mr. Chairman, we pledge to work with the administration and Congress and with others involved in the public policy process to achieve sound solutions. We are willing, even eager, to do whatever we can to be of help.

Thank you.

Chairman DOMENICI. Dr. Roger Molander, president of the Roosevelt Center for American Policy.

STATEMENT OF DR. ROGER C. MOLANDER, PRESIDENT, ROOSEVELT CENTER FOR AMERICAN POLICY STUDIES

Dr. MOLANDER. Mr. Chairman, Mr. Chiles and Mr. Gorton, I am Roger Molander, president of the Roosevelt Center for American Policy Studies, a new nonpartisan, nonadvocacy public policy research institute.

In early 1984, the Roosevelt Center began a major education program on the problem of the Federal budget deficit. As part of this effort, the center convened a bipartisan task force on the Federal deficit, composed of American business, political, economic, and civic leaders, all deliberately chosen from outside Washington, DC. The task force was cochaired by William Hudnut, Republican mayor of Indianapolis, and Bruce Babbitt, Democratic Governor of Arizona.

In convening this task force, it was clear to us, as it was to many others that, without fundamental policy changes, huge Federal deficits would continue into the foreseeable future. But what policy changes?

To seek answers to this question, we staffed this task force with the kinds of policy options papers that we knew would have to be considered if these huge deficits were to be eliminated, and eliminated soon, because to do otherwise would be tantamount to a kind of fiscal child abuse, making our children pay for the inability of this generation of decisionmakers to put its fiscal house in order.

The recommendations of the Roosevelt Center task force on the Federal deficit were released last September, in a report entitled, "Breaking the Deficit Deadlock: A Fair and Simple Plan to Balance the Budget." Details of the recommendation are included in my written testimony.[1] Permit me to summarize.

ELIMINATE STRUCTURAL COMPONENT OF DEFICIT

First of all, the members of the task force concluded that continued huge deficits place our Nation in serious danger, and that immediate concerted action is imperative. Specifically, to ensure the stability of our Nation's financial future, they concluded that the structural component of the Federal deficit should be eliminated and that the Federal budget should, in effect, be balanced by fiscal year 1989.

The task force went on to recommend a specific plan to accomplish this objective, calling for a balanced program of tax increases and spending cuts, each sharing approximately half of the burden. The plan which emerged is in large part based on the principle that Federal tax rates and spending benefits should be linked more closely to genuine need, and that modest concessions must be shared by all but the poor. The recommendations preserve the overall structure of current Federal tax and spending policies but call for practical reforms in the traditionally inviolate areas of Social Security, Medicare and defense.

In tax policy, the approach chosen by the task force to raise revenue was to broaden the tax base, close loopholes, and reduce the use of deductions for keeping a progressive income tax structure with lower marginal rates. Reductions in the projected rate of increases in defense spending made up approximately half the total recommended spending cuts, with the reductions coming largely from procurement. The task force believed that savings could be derived from eliminating the procurement of weapons systems with questionable or obscure objectives, and by avoiding needless duplication of weapons systems. These recommendations resulted in a defense plan which produced a real rate of growth of 3 percent per year, for the next 4 or 5 years.

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[1] See p. 459.

On the domestic spending side, the means testing of entitlements was proposed as the best way to reduce expenditures in this category without cutting benefits for those in genuine need.

Subsidies to agriculture and other industries were reduced; Federal retirement plans were revised, and most grants to State and local governments frozen.

In summary, the proposal recommends a nearly equal split between increased revenues and decreased spending, and evenly divides spending cuts between defense and domestic programs.

REFORM BUDGET PROCESS

The task force also recommended further reform of the budget process, to make mandatory the passage of a single, combined spending and tax bill that would legislate the deficit or surplus for the coming year. Under this proposal, unless such a law were enacted by a hard and fast deadline, no Government funds could be spent in the next fiscal year.

Mr. Chairman, I would like to close my summary of the task force's recommendations by returning to the issue of——

Chairman DOMENICI. Did you say "none"?

Dr. MOLANDER. None. Well, you know what that means.

Chairman DOMENICI. Even the military?

MAGNITUDE OF THE DEFICIT

Dr. MOLANDER. Well, the continuing resolution is the issue, I assume, that they have in mind here. How that would be implemented, as you know, is difficult.

Mr. Chairman, I would like to close my summary by returning to the issue of the magnitude of the deficit. What is a safe deficit? Or better to ask: What is not a safe deficit?

What level of deficit might future generations judge as irresponsible on the part of today's decisionmakers?

When we try to answer such questions, we immediately find ourselves thrown into the world of long-term economic projections—"through the looking-glass."

We wish it were otherwise, but we know from experience that our economists are incapable of making such projections. All we really know is that maintaining deficits in the $200 billion range over the next 5 years will double the interest payments which our children will have to make on our behalf, and probably make forever, since nobody is talking seriously about reducing the national debt.

BALANCE BUDGET BY 1989

When our task force looked at this issue, as I mentioned, their answer was "Let's balance the budget by 1989; let's make that kind of commitment—sort of a 'This will be the extent of our abuse of your future, the extent of the additional debt we ask you to bear,' and we will start the 1990's with a balanced budget."

At the Roosevelt Center, we found this "Let's show them we can do it—and especially that we have a political process that we can do it" kind of outcome to be one of the most interesting decisions made by the task force. It was in effect an expression on the part of this set of American leaders that they were prepared, and they thought that their society was prepared, to do the rethinking of commitments both to our own people and to our friends in the international community that we undeniably will have to do to beat this deficit problem.

We were very encouraged with the outcome of this exercise. It demonstrated that a diverse group of leading Americans could come to grips with the problem of the deficit and reach a compromise solution.

DEFICIT REDUCTION REQUIRES COURAGE OF POLITICAL LEADERS AND CITIZENS

At the same time, we have no illusions about the nature of the political challenge. In staffing the task force, we got a good look at the options papers that led to the task force recommendations. They involved the kind of fundamental issues that clearly cannot be resolved by our Government acting alone. Only the people of this country, virtually staffed by the Government, can make the kinds of decisions that will be necessary. The overriding institutional objective of the Roosevelt Center is to involve the Nation's citizens more fully in this policy decisionmaking process. Action to reduce the deficit will require the courage and vision of both political leaders and citizens.

To this end, as Bill Hudnut, the mayor of Indianapolis, says about this issue, we must ask "Who will peel the hot potato?"

We believe that our Nation's citizens and political leaders in Washington, working together, can and should get on with that job, and that the stimulus for forging that kind of partnership is very much in the hands of this committee. We hope that you and your colleagues on the House side can face this challenge and, later this spring, provide a message that will ignite and engage the American people in this process.

If you will permit me to just lighten up a bit at the end, it is Bruce Springsteen—someone whom President Reagan once cited in the 1984 campaign—who says in one of his songs, "You can't light a fire without a spark." We hope that this Budget Committee can provide that spark.

Thank you.

Chairman DOMENICI. My kids like him, too. He is great.

Thank you.

[The prepared statement of Dr. Molander follows:]

ROOSEVELT CENTER
For American Policy Studies

TESTIMONY OF

DR. ROGER C. MOLANDER

PRESIDENT

ROOSEVELT CENTER FOR AMERICAN POLICY STUDIES

SENATE BUDGET COMMITTEE
FEBRUARY 22, 1985

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Mr. Chairman, distinguished members of the committee, my name is Roger Molander. I am president of the Roosevelt Center for American Policy Studies, a nonprofit, nonpartisan and nonadvocacy public policy research institute.

In early 1984, the Roosevelt Center brought together a thirteen-member task force of business, political, and civic leaders from across the country. Chaired by Republican Mayor of Indianapolis William H. Hudnut, III, and Democratic Governor of Arizona Bruce Babbitt, the task force worked for six months and last September released their report entitled Breaking the Deficit Deadlock: A Fair and Simple Plan to Balance the Budget. The recommendations described in the report are those of the task force. The Roosevelt Center itself does not advocate particular policy solutions.

The task force concluded that while recent deficits may have helped to stimulate growth, the massive deficits we presently face will ultimately overwhelm the nation's hard-won return to better times. Continued mounting deficits will trigger rising inflation and higher interest rates that could lead to a slowdown or even reversal of our current economic expansion. The deficit will increasingly penalize businesses and consumers who need credit, interest-sensitive industries, and exporters. It creates a debt burden that threatens to grow out of control.

The task force determined that the threats to our nation's well-being posed by continued huge deficits make immediate, concerted action imperative. The report offers a fair and simple yet comprehensive plan to balance the budget by 1989, cutting more than a quarter of a trillion dollars from the deficit. These measures should be phased in gradually and crafted to enhance not curtail investment for long-term economic growth.

As individuals representing a broad spectrum of interests, each of the task force members could not support all of the specific proposals advanced in the report. They recognized, however, the need to compromise for the common interest. No longer can elected officials in Washington afford to satisfy the American people's simultaneous demands for more generous benefits, lower taxes, and a stronger defense. We must all recognize that more discipline now will mean less pain later.

The task force's plan is based on the principle that federal tax breaks and spending benefits should be linked more closely to genuine need and that modest concessions must be shared by all but the poor. This principle differentiates the plan from other deficit reduction proposals that call for an across-the-board spending freeze, elimination of alleged waste, or new kinds of taxes. The plan preserves the overall structure of current federal tax and spending policies but calls for practical reforms in the traditionally inviolate areas of social security, medicare, and defense.

The plan would begin in fiscal 1985 to produce an estimated $92 billion in higher revenues to reduce the deficit in fiscal 1989. It would also cut projected spending by $94 billion in fiscal 1989--$45 billion in domestic spending and $49 billion in defense--and cut interest costs by $66 billion.

TAX POLICY

The plan proposes to broaden the tax base and make the tax system fairer and simpler by:

- Limiting the amount of itemized deductions to those exceeding a percentage of adjusted gross income.

- Treating untaxed fringe benefits as regular income when such benefits (other than employer contributions to retirement plans) are well in excess of benefits typically provided.

- Counting social security payments as income to high-income recipients once those payments exceed their social security contributions, and taxing certain other transfer payments.

- Broadening the definition of income for wealthy taxpayers subject to the alternative minimum tax.

- Eliminating certain exclusions from income, such as dividends and reinvested utility dividends, and certain tax shelters, by allowing business losses to be deducted only from income earned in the same business activity.

- Freezing excise taxes now scheduled for reduction and other planned tax breaks, such as levies on estates and gifts.

- Adopting a minimum corporate income tax of approximately 20 percent akin to the broadened alternative minimum tax for individuals.

The task force opposes the imposition of a surtax on income because it would only worsen the inequities of the current tax system and raise marginal tax rates. The task force supports indexing as a necessary change to protect low- and middle-income families from inflation-caused "bracket creep."

These reforms move in the direction of modified "flat tax" proposals but maintain progressive rates and permit lower rates on widened definitions of income. Taken together, they would raise $92 billion by fiscal year 1989.

Social Security and Medicare

The task force's examination of the social entitlement programs was based on a deep commitment to the principle of dignity and security in old age and declining health. For many older Americans, however, the United States actually overachieves the objective of providing retirees with an income sufficient to match living standards during the period of working life.

The task force's proposal acknowledges that considerable political courage will be required to revise these programs but cites an increasing recognition that the problems are serious and must be addressed without breaking commmitments to older Americans or imposing large new tax burdens. To this end, the task force makes several recommendations.

Limiting Benefits to High-Income Beneficiaries: Many high-income beneficiaries of social security retirement payments have little need for them. Some members of the task force therefore supported means-testing of social security benefits. Other members preferred an approach that would avoid the use of social security payroll tax revenues, which are drawn from workers of all incomes, to supplement the resources of high-income beneficiaries.

One such approach is to recognize the difference between earned and unearned benefits. The earned benefit is what can be financed over expected retirement years by an employee's contributions to social security, the employer's match of those contributions, and earnings imputed to the fund thereby created. This is the pension benefit, the argument goes, to which society has committed itself. Like a private pension, this benefit would not be means-tested. But the substantial sums paid over and above that amount are not part of this commitment and should not go to persons with high incomes from other sources. The cost-of-living adjustment (COLA) falls in this category. When it goes to high-income beneficiaries, it constitutes a subsidy and should be limited. The mechanics of implementing this proposal are discussed below in connection with a comparable proposal for dealing with the subsidies that medicare provides to high-income beneficiaries.

Medicare: The medicare program has helped to finance, and probably to cause, an escalation in health care costs from 4.4 percent of GNP in 1950 to 7.9 percent in 1972 and 10.5 percent in 1982. As with social security, its benefits are provided to all eligible persons regardless of need.

Medicare is unlike social security in two important respects. First, the financing crisis in medicare will arrive soon. Second, medicare costs are paid partly from federal general revenues. These two factors make reform of medicare all the more urgent.

One key to controlling the costs of medicare is controlling the costs of health care generally, which also causes substantial upward pressures on federal spending for veterans' health benefits and medicaid. The task force shares the overriding national concern for controlling these costs. But recently enacted changes in provider reimbursement procedures designed to control costs are untested. Therefore, the report does not assume further savings from cost control measures.

Without further substantial short-term improvement in controlling the costs of health care, the question becomes the fair allocation of these costs among groups in our society. The current medicare program fails in this respect.

One of Americans' greatest fears is the enormous burden associated with catastrophic hospital costs. These costs are not fully covered by medicare or private health insurance. Yet for those affected, these are the costs that can wipe out a lifetime of savings and force patients and their relatives either to pay for expensive procedures or to forego such care to preserve the living standards of those who survive. This is a cruel choice that should not be inflicted on older Americans.

Medicare coverage is adequate for routine costs, including physician out-of-hospital care and the first 90 days of hospital care. The costs of outpatient coverage (provided by Part B of medicare) are covered by a combination of limited co-payments by recipients of service, premiums for the insurance coverage paid by those covered, and the general taxpayer. A substantial number of those who receive the taxpayer subsidies are more affluent than the persons paying their medical bills. The task force report proposes the following:

Catastrophic Coverage: Full catastrophic coverage would be provided to all medicare recipients. To prevent possible abuse of this coverage, peer review safeguards would be established to evaluate the course of treatments.

Co-payments and Deductibles: Medicare requires relatively low co-payment of costs and deductible amounts compared to many private plans. The report does not advocate major changes in these cost-sharing requirements. But as long as social security cash payments are indexed to a measure of cost of living that includes medical costs, the co-payments and deductibles should also be raised periodically.

Premiums: While the Part B program began with 50 percent sharing of the costs by general taxpayers and beneficiaries, the beneficiary percentage fell to 25 percent in fiscal year 1984. Keeping this percentage low provides no benefit to the lowest-income persons in the program because their premiums are already paid by state governments using state and federal medicaid funds. To restore the original cost-sharing arrangement and in return for new catastrophic coverage for all beneficiaries, the task force proposed that premiums should again finance a higher proportion of the Part B coverage for at least high-income beneficiaries, with a sliding scale of premium responsibilities for those with above-average incomes.

Limiting Taxpayer Subsidies: The task force could see no reason why the average taxpayer should subsidize the medical costs of high-income persons. There are a number of ways to prevent such subsidies, such as requiring higher sharing of costs of medical services provided and use of the tax system to recover costs. Because of the administrative difficulties in operating such a payment requirement any other way, the study proposes that it operate through the tax system and relate only to the taxpayer share of the Part B insurance costs, not to the receipt of medical services covered by the program.

The tax system would bill high-income medicare beneficiaries in the following year's tax bill for the taxpayer-subsidized portion of the medicare insurance premium. The social security COLA increase for high-income beneficiaries would be recouped in the same way. There would be a sliding scale ranging from no recoupment from persons with income below $25,000 ($32,000 for couples) to full recoupment from persons with income above $50,000 ($76,000 for couples). A simple calculation on the income tax form would be used to recoup taxpayer subsidies. Income from all sources (including tax-exempt interest and social security) would be included.

GRANTS

The task force concluded that considerable improvements can be made in the way the federal government makes grants to state and local governments. With annual spending levels of $100 billion, these programs clearly must be considered in any broad-based strategy to balance the federal budget.

Federal grants have three distinct objectives. The first is to support a means-tested safety net through cash assistance (AFDC), food stamps, medical care (medicaid), and subsidized housing. These programs involve assistance to needy people. State and local governments are conduits for this assistance.

Federal funding for programs for needy people is appropriate. The continuing mismatch between fiscal capacity and need in states and localities makes the redistributive impact of federal taxation and funding important. For example, without federal participation, Mississippi--with the highest percentage of poverty in the nation and the lowest tax capacity--could not maintain a safety net as strong as those of wealthier states. While some of these programs could be made more effective and less costly, we do not believe that they should be reduced to close the deficit.

Second, there are also federal grant programs, of which the highway program is most significant, that are funded through trust funds with earmarked revenues. The revenues and expenditures of these trust funds are supposed to be equal. Cuts in spending would therefore result in equal cuts in revenues without impact on the deficit, provided that the trust fund concept is maintained.

The remaining federal grant programs represent the use of general federal tax dollars to support functions of state and local governments. These include economic and community development, higher education, elementary and secondary education, water supply and sewage disposal, law enforcement, parks and recreation, transportation, and public health. People interested in such functions welcome federal financial participation in meeting their costs, as do state and local officials.

But federal grant support of these traditional state and local activities has a number of disadvantages that become increasingly apparent as the federal role in financing shrinks relative to the state and local role. First, federal aid has high administrative costs both at the federal level and at the state and local level. Second, federal aid requirements often increase program operating costs. Third, a variety of federal grant conditions often keep state and local officials from applying funds where they feel needs are greatest.

In addition, federal grants have failed to achieve many of their basic purposes. They do not draw state and local funding to areas of particular federal concern because federal assistance now covers practically every facet of state and local operations. Nor do they transfer resources from more affluent areas of the country to less affluent ones. In fact, the reverse occurs. In fiscal 1983, the two states with the largest per capital federal grants--Alaska and Wyoming--had the highest fiscal capacity in the nation. Finally, there is the traditional argument that those responsible for spending public money should also be responsible for raising it.

Given these circumstances and the deficit problem, new concepts should be applied to grants that are not used for safety net programs or financed by user charges.

Funding Freeze: The absolute dollar amount for these grants should be frozen at fiscal 1984 levels until the deficit problem is behind us. The freeze should be applied to total spending for the affected grants, but not to each program so that lower priority programs can be reduced to make room for increases in higher priority areas.

The impact of a freeze on state and local services can be reduced by giving state and local governments more flexibility in the use of funds. Narrow categorical programs should be consolidated into broader ones, and federal requirements should be reduced. This less obtrusive federal role would be particularly appropriate as the federal role in financing these activites declines.

Means-Testing of Grant Programs: Most federal grant programs do not consider the fiscal capacity of state and local governments in grant formula allocations or in the percentage of cost sharing required of recipient governments. For example, block grants for social services provide equal amounts per capita to every state, and grants for aging provide equal amounts per older American without regard to the differing capacity of recipient jurisdictions to provide resources from their own tax bases.

The task force members believe that federal grant programs should better reflect the fiscal capacity of recipient governments, just as they propose cutting entitlement-type benefits to high-income citizens. The exact mechanism for implementing this recommendation would vary from program to program. For example, the general revenue sharing formula should not give more per capita to Alaska, with low personal taxes, than to states with higher personal taxes.

As federal programs shrink in relation to state and local effort, some measure of fiscal capacity should find its way into their formulas. Ultimately, current federal grant programs, other than means-tested grants for individuals and grants associated with user charges, would evolve into one or more mega-block grants with few strings attached. Such grants would finance a declining share of state and local spending but would help offset disparities in state and local fiscal capacity. This proposal would neither cut nor raise grant spending but would enable limited funds to be used more effectively.

OTHER DOMESTIC PROGRAMS

The task force members concluded that applying some general principles to other budget items not separated out above would contribute substantially to deficit reduction and to improved national economic performance.

Subsidies to Particular Industries: The proposals encourage the continuation of a large federal role in providing direct assistance to those who are the victims of illness, disability, unemployment, and changes in economic conditions.

With strong safety net programs in place, the government should eliminate as quickly as possible tax breaks and spending programs designed to provide benefits to particular industries. These programs are a poor substitute for safety nets because they base their subsidy on the amount of activity by individuals and corporations, such as acres farmed, crops produced, or gas extracted. Thus, they are targeted to those who own the most, not those whose need is greatest. Farm price support programs, which increase prices to consumers and reduce earnings from agricultural exports, best exemplify this kind of subsidy. Other examples will be found in the tax code, with special benefits for industries such as timber and shipping, and in federal loan programs.

User Charges: Subtle subsidies amount to substantial federal spending. The expenditures are not necessarily wasteful, but the costs are imposed on the general taxpayer rather than on the users of the services provided. Examples are federal spending for such purposes as maintenance of inland waterways and support for the luxury sport of salt-water boating.

Compensation and Retirement: The task force endorses the general principles that compensation offered to federal employees should be comparable to that offered private sector workers peforming comparable work. This principle, if applied consistently, could raise some federal salaries, notably those of higher level officials. But such increases for a small number of individuals would be offset by decreases elsewhere.

The comparability standard should be applied to the full compensation package, not just to salaries. Federal pension benefits are considerably more generous than those provided to workers in the private sector. One significant difference is the automatic cost-of-living adjustment, which encourages retirement when employees believe that it is likely to grow faster than federal wages.

Similar changes in the military pension system would generate enormous long-run savings because the retirement period is so long as a result of early military retirement. The military pension system, particularly as its affects persons between normal military retirement and age 65, is so expensive that it would be possible to use the savings both to reduce the deficit and to enhance recruitment through greater front-end incentives for enlistment and initial re-enlistment.

DEFENSE

In the increasingly uncertain world of the 1980s, no amount of defense spending can restore the security from attack that the United States enjoyed before the age of long-range nuclear forces. The continuing growth of Soviet military power and the persistent instability of critical regions of the world present challenges to our interests that our defense policy and planning must meet.

Like the Reagan Administration, leaders of both major parties, and most defense experts, the members of the task force believe that this situation calls for continued real growth in defense expenditures. But three other convictions have also shaped their consideration of the defense budget.

First, the long-term U.S. defense program must be both politically and financially sustainable. To this end, the defense budget cannot be exempted from the choices between the desirable and the fiscally possible that we have addressed in other areas.

Second, economic strength and growth are fundamental to military security, especially viewed over a period of years. Reducing the deficit is an essential step in sustaining such economic strength and growth.

Third, less rapid growth in defense spending can be compatible with, and can enhance, the effectiveness and readiness of our military forces. The task force members attached particular importance to ensuring that our non-nuclear forces are maintained to high levels of effectiveness and readiness.

Three general themes dominated the study's approach to the defense budget:

- The importance of achieving a strong and more visible connection between our security objectives and the military forces and equipment we buy to promote them.

- The need for stability and efficiency in our defense programs. Stable funding for key procurement programs avoids the costly "peaks and valleys" in funding so common in recent years. We must also avoid waste and unjustified duplication.

- The importance of making militarily sensible choices in determining missions and equipment.

These general themes led the task force to look for several kinds of changes in the current five-year defense program:

First, changes in procurement programs with questionable or obscure objectives. Examples of programs that should be examined on this ground include the proposed additional aircraft carrier battle groups and the MX missile.

Second, removal of unjustifiable duplication in procurement. For example, the task force supported the provision of effective close-air support of our ground forces but believes that a choice should be made between competing programs like the A-10 close support aircraft and the AH-64 attack helicopter. They also supported the provision of naval air power but believe that choices should be made among the aircraft designed for this purpose, such as the F-14, AV-8B, and F/A-18 aircraft.

Third, slowing the pace of certain programs, especially those with persistent technological problems. The M-1 tank is an example.

Fourth, additions to the current program that would ensure more effectivenss per dollar and more stable production as well as compensate for potential reductions in other areas. These include more rapid production of tactical fighter aircraft, Army trucks, and some kinds of ships, as well as more, and more modern, equipment for the National Guard and Reserves.

Fifth, reforms designed to increase efficiency, notably by improving the management and stability of acquisition programs. These reforms will require action by Congress on the Reagan Administration's acquisition improvement program (the "Carlucci" reforms) and the implementation of several procurement reforms proposed by the Grace Commission.

Sixth, reductions in the growing backlog of unspent appropriations by rescinding authority to obligate funds appropriated in prior years for programs cancelled or modified for one of the reasons given above.

The need for political sustainability and for military and economic efficiency suggests that such a program can best be achieved by establishing core force levels in fiscal 1985 and providing for necessary modernization and expansion within a 3 percent annual rate of growth of spending in real terms. This approach of steady, sustainable modernization of our forces will better serve our security than current proposals. In particular, it will help to avoid future choices between maintaining the planned rates of procurement and providing adequate resources for operation and maintenance of the modernized forces and for longer-term research and development.

Using this approach, the members of the task force are confident that the United States can deploy and maintain military forces at high levels of readiness, including:

- Strong and modern nuclear forces for deterrence.

- Ground and air forces equal in size and close in capability to those currently planned, with greater than planned strength in the National Guard and Reserves.

- Naval and amphibious forces capable of undertaking the full range of politically and militarily plausible missions.

- Support forces capable of sustaining U.S. forces in combat in the principal contingencies and regions in which they might be engaged.

These recommendations do not require significant reductions in current military manpower levels.

Finally, a healthy U.S. economy is the foundation of the security of our allies and friends. Many of them see the reduction of the deficit as a precondition of their own economic recovery. Our allies and friends should therefore complement the politically difficult measures proposed for reducing the deficit by assuming a greater share of the non-nuclear defense burden--accepting certain specific defense tasks currently performed by U.S. forces.

THE FEDERAL BUDGET PROCESS

As the task force members struggled with difficult choices about federal revenue and spending, they wondered why such problems were allowed to develop in the first place and why our institutions for guiding national policy are unable to correct them quickly or at least before a crisis develops.

There has always been concern that executive branch and congressional processes encourage fragmented consideration of revenue and spending without producing a coherent fiscal and economic strategy. The executive branch has acted to prevent or minimize such problems by establishing an executive budget process and an Office of Management and Budget, "unifying" the budget so that more federal spending and revenue is encompassed within the budget process, and creating the President's Council of Economic Advisers to help link fiscal policy with overall economic policy.

Congress made similar changes in the 1970s when it created the Congressional Budget Office and established a schedule for consideration of budget matters.

Despite these changes, there is a massive deficit, and neither the executive branch nor Congress has taken action that would reduce the deficit to manageable proportions. Budget targets have been adopted but not enforced, and the schedule for appropriations has not been followed. Congress maintains a limit on federal debt, but this ceiling is regularly raised, as it must be, after debate that has no impact on restoring fiscal order.

Correcting the Spending Bias: Many proposals have been advanced to correct the so-called spending bias of the federal budget process. These proposals include presidential line-item veto authority, strengthened presidential authority to rescind or defer spending, devoting more attention to the capital and credit budgets, biennial appropriations, making the first budget resolution binding, and requiring super-majorities to pass tax or spending bills. Some of these proposals have independent merit, but the task force was not convinced that they would alter the forces that produce current tax and spending policies.

Similarly, they do not believe that a constitutional requirement for a balanced budget can solve the deficit problem. Some observers believe that voter initiatives in several states may rekindle the movement initiated by state legislatures to achieve a balanced budget through constitutional amendment. But even if this movement is given new life, the task force members remain skeptical of such an amendment.

Part of the problem is the climate of public opinion in which federal officials operate. The American public, while supportive of a balanced budget, strongly favors low taxes and high spending and has not faced up to the consequences of seeking both.

But even an informed public opinion could not easily discipline the process that produced the current deficit problem. In the 1984 elections, candidates for the presidency and Congress, almost without exception, campaigned against the deficit. If voters wanted to turn out of office those members of Congress "accountable" for all the problems caused by the deficit, whom would they select?

A "Truth-in-Budgeting" System: What the federal government lacks is a clear and binding vote on a bill--passed by Congress and subject to veto by the President--that provides: (1) the taxes applicable to the budget year and estimates of the revenue to be raised from such taxes; (2) the spending approved for the year; and (3) the resulting deficit or surplus. Of all the procedural solutions considered by the task force, moving to such a "single bill" approach seems the most promising. It would reduce the power of individual congressional committees and increase the accountability of all Members of Congress by forcing major decisions on taxes, spending, and deficits to be made together.

But a single bill would not solve a second major problem: the repeated failure to adopt substantive appropriations bills before the beginning of the fiscal year. This problem can be solved only with a requirement that all action governing taxes and appropriations take place on time. Continuing resolutions, which postpone hard decisions, should be eliminated, and supplemental appropriations should be used only in isolated cases when unanticipated events change spending needs. If the single bill were not passed and signed by the beginning of the fiscal year, the government would lack the authority to spend funds and would have to shut down.

This "truth-in-budgeting" system draws on the practical experience of many state and local governments. Like other process changes we have reviewed, it could be ignored in practice if Congress and the Administration have other tax and spending priorities. Some believe that a constitutional amendment incorporating this "truth-in-budgeting" system would represent a mandate from the people and would therefore be harder to ignore.

The task force's study of the federal deficit led them to the conclusion that the nation's fiscal policy is on a dangerous course that must be changed. Their plan to eliminate the structural deficit over the next five years and beyond contains elements that may offend those who bear the costs. But the long-term benefits of deficit reduction far outweigh the short-term costs. The plan distributes the burden fairly and without radical departures from current tax and spending policies. The costs of deficit reduction, caused by higher taxes and lower spending, will be immediately apparent to those affected by them. The benefits of deficit reduction may appear more slowly but are substantial. They include heightened prospects for low inflation and a decline of interest rates, stability in the international financial system, and sustained economic expansion. These benefits would mean a higher standard of living and greater economic security for the average citizen.

The task force report represents the attempt of a diverse group of concerned Americans to understand the deficit problem more clearly and to address it responsibly. The Roosevelt Center's overriding objective--to involve the nation's citizens more fully in the policy process--is also important to the deficit question. Action to reduce the deficit question will require the courage and vision of our political leaders. But it will depend ultimately--as the members of the task force experienced first hand--on the American people's understanding of both the issues involved and the need to make hard choices. As task force co-chairman Bill Hudnut asked: "Who will peel the hot potatoes?" It is time for our political leaders here in Washington and our nation's citizens to get on with the job.

Chairman **Domenici**. Mr. Donald Platten, the chairman of the executive committee for Chemical Bank. We welcome you.

STATEMENT OF DONALD C. PLATTEN, CHAIRMAN, EXECUTIVE COMMITTEE, CHEMICAL BANK

Mr. **Platten**. Mr. Chairman, I am chairman of a subcommittee of the committee for economic development; my other hat is the chairmanship of the executive committee of the friendly Chemical Bank.

Chairman **Domenici**. All right. Excuse me.

Mr. **Platten**. The full text of my testimony, I think, is before you, but before going on, I would just like to express the hope that the summary of our paper that the subcommittee did, "Fighting Federal Deficits: The Time for Hard Choices," would be part of the record, too.[1]

I came in a little around 10:30, and I heard somebody saying something about Mr. Washington, so I might be a little repetitive here. But up in New York in our local newspaper, George Washington has again been making news. And in tribute to Mr. Washington, the Times reprinted excerpts from his Farewell Address, in which he warned us about debt and cautioned against "ungenerously throwing upon posterity the burden which we ourselves ought to bear."

Mr. Washington was right. What he recognized those many years ago is the simple fact of life, for governments as well as for individuals and households: If we, nations or individuals, keep piling debt upon debt, the burden can become too heavy to bear. And as a banker, I can also tell you that at some point, too much debt means that people are going to stop lending you money.

PROSPECTIVE DEFICITS CALAMITOUS AND DAMAGING

In the CED report which was issued last fall, we called prospective Federal deficits calamitous and extraordinarily damaging. We concluded—and I personally agree—that continued growth of deficits is the single most important obstacle to sustained noninflationary growth facing this nation.

To make the point more vivid—and I emphasize this, because it struck me vividly—if current projected deficits are allowed to grow unchecked, 5 years from now just the interest costs alone will be $230 billion a year. That amount is virtually identical to total Federal outlays for fiscal 1972.

To me, that is reality, or it is unreality, however you want to phrase it. But the numbers alone cannot really illustrate the damage that deficits are doing. Budget deficits are seriously distorting the economy. They are putting upward pressures on interest rates, exchange rates, and the trade deficit. They are hurting, as you know, all businesses exposed to foreign competition. They are slowing growth in our capital-intensive and high-technology sectors.

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[1] See p. 500.

Budget deficits are destabilizing; unchecked, they have the very real potential for fueling future inflation and recession and for causing flareups of a sudden financial crisis.

Budget deficits are like breeder reactors—they fuel themselves. Ever-increasing deficits means that a larger and larger proportion of GNP wlll have to go to paying interest alone.

And finally, an unending stream of big deficits undermines our Government's ability to manage its affairs, and this can threaten the orderly functioning of our society.

Certainly, we have survived the deficits so far. The deficits that loom ahead are a cancer in our economy and our society, and this cancer could eventually kill us. But it is a treatable one, and that is why I find delay or inaction in reducing the deficit so very frustrating.

During the past few years, our country has come a long way in pulling itself out of a deep recession, in cutting inflation and in putting millions of Americans back to work. This has been a real achievement. But now we need to attack the rest of our problems.

CUT GOVERNMENT EXPENDITURES AND INCREASE REVENUES

In brief, our recommendations are that Government expenditures must be cut and revenues increased. These actions must be equitable, and they must be shared by as broad a base as possible.

Our recommendations cover both short and long term. Some of the recommendations we make can be phased out after a few years when longer term solutions have had time to become effective.

WE CANNOT GROW OUR WAY OUT OF THE PROBLEM

In facing up to the deficit, we urge you to keep two things in mind. No. 1, is that we cannot grow our way out of the problem. I believe that the administration's assumptions on growth and deficit reduction are overly optimistic, to say the least. The fact is that a substantial portion of future deficits is structural, and this structural spending will outpace revenues even with noninflationary economic growth.

SPENDING CUTS OR REVENUE INCREASES ARE NOT ENOUGH

No. 2 is that we cannot reduce the deficit sufficiently by relying on spending cuts or revenue increases alone. As you know, the principal spending cuts that have been made in recent years have affected means-tested entitlement programs and nondefense discretionary programs. We believe that means-tested programs have already been cut back about as much as they should be, and that it is not right to ask the poor to bear any more of the burden that should be shared by all. And while more longrun saving can be achieved from discretionary spending, the total dollars to be gotten from this part of the budget really are not large.

DEFENSE AND SOCIAL SECURITY NEED TO BE ADDRESSED

We thus concluded that to significantly reduce the budget deficit, we need to go where the money is—to defense spending and to nonmeans-tested entitlements.

In our discussion of defense spending last year, we concluded that defense expenditures should be held to no more than a 5-percent increase in real terms for 3 years. Today, we would recommend a lower limit. As we begin to achieve a better and more efficient phasing in of major weapons systems, this in itself would help slow the rate of spending increases.

Social Security and Medicare both have to be addressed. For Social Security, we are recommending that cost-of-living adjustments be made to two points less than the full CPI for 3 years. And to ensure Medicare's solvency, we think a bipartisan commission along the lines of the Greenspan Commission on Social Security would be very much in order.

REVENUES WILL HAVE TO BE INCREASED

It was also our conclusion that even a very stringent spending restraint program will not be enough to reach the deficit reduction targets we recommended. This leads to an unpopular but inevitable conclusion that we have to increase revenues.

For the long term, almost everyone agrees that the tax system needs a major overhaul. But even on a fast track, implementing major tax reform is, in our opinion, several years away. In our deliberations, we felt that there were revenue actions that should be taken now that would begin promptly to raise additional revenues. This could be done by broadening the tax base, eliminating low-priority tax preferences, and imposing additional excise and user taxes.

We believe that the new system of tax indexing is a desirable reform, and that it is correct to protect taxpayers from the effects of inflation. But reducing the deficit is such a compelling need now that we recommended indexing taxes to 2 points less than the full CPI, again for 3 years.

Finally, as a last resort, we called for a temporary income tax surcharge on individuals and corporations, combined with a higher minimum tax.

I should point out that, while overall, our report was unanimously approved by the CED trustees eligible to vote on it, a number of the trustees had strong reservations about the recommendation for the surcharge—as a matter of fact, their stomachs turned over. But their argument was a simple one. A surcharge would add further distortions to the tax system. As is CED's usual practice, these reservations are published in the back of the policy statement.

Although I appreciate that there are a number of specific differences between what our study recommends and what you may be currently contemplating, it would appear that CED would support in principle the approach outlined by Senator Dole 2 weeks ago, at least for fiscal year 1986. If my understanding is correct, this proposal would set a goal of reducing deficits by $50 billion by next year and to 2 percent of GNP by 1988, and is predicated on freezing spending for 1 year, including Social Security and possibly, defense. This apparently still leaves a sizable additional amount that would have to be derived from other sources.

If all of these extra funds are to be raised through spending reductions, this will call for very difficult choices in program areas that have already been affected by previous budget cuts. As I have already noted, when we at the CED met to consider these choices, hard choices, we did not believe it possible to fill all of the gaps from the discretionary area. Hence, our tax recommendations.

But you, Mr. Chairman, and your counterpart on the House side have indicated that tax increases will not be considered as part of the effort to reach the first-year goal. I sincerely hope that you will be able to review that decision if, in fact, it turns out that the spending reductions will not be enough to meet the target.

LINK INCREASED REVENUES TO EXPENDITURE REDUCTIONS

If I can leave you with one key thought, it is that we firmly believe that any actions to increase revenues must be linked, and linked forcefully, to expenditure reductions. We cannot simply raise taxes and pay lip service to cutting back on spending.

We are also very aware how hard it is to reach a consensus on these difficult issues. Right now, it is one of CED's most important goals to help build public understanding and support for the policies that need to be enacted to reduce the deficit. We at CED are committed to keeping the pressure on, and I hope that you will let us know how we can help.

I might just finish by saying that in my 97 years in business, I have found that there is a great deal to base actions on the working hypothesis that what is necessary is possible, and I think that the reduction of this deficit is not only possible, but absolutely necessary.

Thank you.

Chairman DOMENICI. How many years of business experience?

Mr. PLATTEN. That was a little hyperbole.

Chairman DOMENICI. All right. Thank you.

[The prepared statement of Mr. Platten follows:]

Testimony of Donald C. Platten

Chairman of the Executive Committee

Chemical Bank

and

Chairman, Subcommittee on Economic Stabilization and Growth

Committee for Economic Development

Before

The Committee on Budget

United States Senate

February 22, 1985

Mr. Chairman, my name is Donald C. Platten, and I am Chairman of the Executive Committee of Chemical Bank. During the past two years, I also served as Chairman of the CED subcommittee on Economic Stabilization and Growth that produced what I believe to be an important and timely report entitled Fighting Federal Deficits: The Time for Hard Choices.

The message of the CED statement probably comes as little surprise to you--we need to take determined action **now** to reduce the deficit. That action should be taken both for the short term and long term. We believe the deficit should be reduced to not more than 2% of GNP within three years and to balance within five. This should be accomplished first and foremost through spending reductions, but revenue increases will also be needed if we are to achieve our long term goals. Finally, the entire budget, including defense and entitlement programs, has to be on the table.

Mr. Chairman, we know that reducing the deficit will prove as tough a test of the American political process as this nation has faced in many years. But I am encouraged by the kind of leadership that you and your colleagues are providing to prevent the deficits from becoming the ruination of the U.S. economy.

To be sure, many sectors of our economy have been getting along pretty well so far despite our huge budget deficit. But we must not be lulled into a false sense of security. In our report, we cited four major ways in which these deficits will over time inflict more and more damage on the economy. These four ways remain just as valid now as reasons why the deficits must not be tolerated as when we wrote the report last year.

First, these deficits--now estimated to add one and a quarter trillion dollars to the national debt in the next five years if no action is taken--create a very serious distortion in the economy and are undermining its long-term potential for balanced economic growth. One of the most disturbing aspects of this is that over the long run, the deficits will reduce the capital stock and lower living standards for future generations. But the economic distortions brought about by the deficits through upward pressure on interest rates, exchange rates, and the trade deficit are already extremely damaging right now, particularly in all the industries exposed to foreign competition and to the capital-intensive and high technology sectors.

Second, unchecked growth of the deficit has to increase the risk of future inflation or recession and sudden financial crises. These could occur, in particular, if confidence in this country's economic performance becomes undermined and there are sudden shifts in exchange rate levels and the direction of capital flows. Moreover, the continuation of the huge trade deficit, which is related to the budget deficit, is bound to intensify pressures for protectionist measures. Without a change in policies, the projected interest costs in 1990 will be more than all Federal expenditures in 1972.

Third, the currently projected deficits will lead to an increase in interest costs on the federal debt that is simply not sustainable over the long run. As long as the deficit causes the debt/GNP ratio to increase continuously, as would be the case without further action, an ever-increasing proportion of GNP would have to be devoted to increased taxes just to pay for the added interest on the debt. Eventually, this will mean a need for more and more draconian spending cuts and/or tax increases to solve the problem.

Finally, failing to face up to the deficit problem will increasingly undermine any respect for rules of budgetary discipline and pose a serious threat to the orderly functioning of our democratic society.

In approaching needed solutions to the deficit problem, our Committee put its first emphasis on developing target paths for deficit reduction that make economic sense and will be convincing to the financial markets. We recommended a strategy that will produce a steady, year-by-year decline in the projected deficit and result in essential budget balance by the time the economy is estimated to reach high employment. We also thought it essential that enough progress be made within the next three years so that the debt/GNP ratio will be stabilized and shift to a declining path thereafter. In the current context, that kind of approach calls for a deficit of roughly $100 billion or 2 percent of GNP by fiscal year 1988 and budget balance by 1990.

Mr. Chairman, I am particularly pleased that these are exactly the kind of goals you are supporting. I urge the committee to continue to place its focus on the bottom-line target--on what the deficit should be after cuts are made--and to emphasize a multi-year time horizon.

Those who believe we can grow our way out of the deficit in an orderly and non-inflationary fashion are not facing up to reality. This simply will not happen. A substantial portion of future deficits is structural--mandated spending which will outpace revenues in the years ahead even in a high employment economy.

I might also say in this context that I find the Administration's budget estimates for the next five years not very credible. The assumptions that economic growth will average nearly 4% a year for five more years and that the Treasury bill rate may fall to 5% by 1990 may turn out to be correct. But I would not want to bet on it. And even with these optimistic assumptions, the budget still remains with a deficit that is too large.

There are still those who believe that, even with non-inflationary growth, we can reduce the deficit through spending reductions alone. As a businessman, and an individual taxpaper, I wish this were true. But although we favor very tough spending restraints that are consistent with broad national objectives, our committee saw no way to achieve the recommended goals without virtually eliminating all discretionary spending outside of defense. This would not only be impractical but would be bad public policy.

Our report does recommend a program of forceful, broadly-based restraints on expenditures. We stress the need to include both defense and entitlements in addition to non-defense discretionary programs. Basically, I see no way to achieve the amount of deficit reduction needed without every area taking some fair share of the pain. Although the precise numbers cited in our report have in part been superseded by the new budget numbers issued this month, the basic dimensions of the problem and of our proposed solutions have not changed very much.

In the area of the defense budget, we recommend that increases in budget authority be held to no more than 5% in real terms per year over each of the three years, starting with fiscal year 1985. I believe that in the current context, our recommendation for the next three years could well be a somewhat lower number. In any case, we also consider it essential that restraint on defense spending include a slow-down in the planned pace of major weapons procurement and related outlays--not by stretching out production schedules for individual weapon systems to inefficient lengths, but by introducing fewer weapons systems at the same time.

In the area of non-means tested entitlements, we concluded there is a compelling case for including a reduction in the cost of living adjustments for three years. Our preferred method was to limit COLAS to the CPI minus 2 percentage points during this period. However, we consider the precise method for reducing COLAs in the next three years less important than the principle that entitlements--including social security--must make some contribution to the deficit-reduction goal. For the longer run, we called for consideration of a wider range of options affecting not only social security but medicare, public pension programs and agricultural benefits.

It was our conclusion, nevertheless, that even very stringent spending restraints will not be sufficient to achieve the tough deficit-reduction targets we have recommended. Hence, we included a series of possible tax increases in our recommendations.

For the longer run we support a basic reform of the tax system. Such a system should make it possible to raise needed additional revenue in an equitable manner. But because we felt such a reform would take several years to be put in place, we called for a series of revenue-raising measures to be used in the interim.

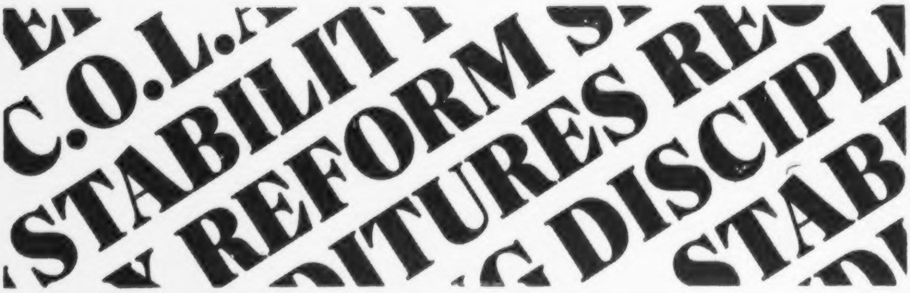
We stressed that any program for raising revenues focus on the following approaches: base broadening, provided that these measures are consistent with longer-term requirements of economic efficiency and equity; excise and user taxes; and a temporary limit on tax indexing. The latter recommendation calls for a limit of CPI minus 2 over the next three years and is coupled with the similar recommendation we made on non-means tested entitlement programs. I should point out that our recommendation on deferral of tax indexing applied only to incomes above a minimum level in order to minimize adverse effect on taxpayers in the lowest tax bracket.

Finally, we called for a temporary tax income surcharge on individuals and corporations, combined with a higher minimum tax. The surtax would be included only as a last resort, and would be subject to a maximum time limit of two years after significant spending reductions had been achieved. I should point out to members of this committee that while our overall report was unanimously approved by the CED trustees authorized to vote on the report, there were reservations on this particular recommendation for a tax surcharge. A significant number of my colleagues, some of whose views can be found in the dissenting memoranda starting on page 64 of the report, argue strongly that such a surtax would further exacerbate the economic distortions suffered under the existing income tax system.

Although I appreciate that there are a number of specific differences between what our study recommends and what you may be currently contemplating, it would appear that CED would support in principle the approach outlined by Senator Dole two weeks ago, at least for FY86. If my understanding is correct, this proposal would set a goal of reducing deficits by $50 billion by next year and to 2 percent by 1988 and is predicated on freezing spending for one year, including social security and possibly defense. This apparently still leaves a sizable additional amount that would have to be derived from other sources.

If all of these extra funds are to be raised through spending reductions, this will call for very difficult choices in program areas that have already been affected by previous budget cuts. As I have already noted, when we at the CED met to consider these choices, we did not believe it possible to fill all of the gaps from the discretionary area. Hence, our tax recommendations. Both you, Mr. Chairman, and your counterpart on the House side have indicated that tax increases will not be considered as part of the effort to reach the first-year goal. I sincerely hope that you will review that decision if, in fact, it turns out that spending reductions will not be enough to meet the target.

In conclusion, I feel there is now a rare opportunity to do the kinds of things that will be necessary to achieve long and short-term deficit reduction. I am encouraged that progress is being made towards this goal and commend you for the leadership you are providing. It is our firm conviction that unless the budget is brought under control, the economic progress that has been achieved during the past several years could be seriously jeopardized. We at the CED are committed to keeping tne pressure on. Let us know how we can help.



CHAPTER 1

INTRODUCTION AND SUMMARY OF RECOMMENDATIONS

For over forty years, the Committee for Economic Development has addressed some of the nation's most crucial economic and social problems. During that time, few developments have posed such serious problems for our economy and its prospects as the huge and growing federal budget deficits that loom in the years ahead.

The federal budget deficit is projected to be around $170 billion in 1984. Moreover, the Congressional Budget Office (CBO) estimates that in the absence of further policy actions, the federal deficit will rise to over $260 billion by 1989. That would still be nearly 5 percent of the Gross National Product (GNP) and would mean that payments of just the annual interest on the federal debt would be equivalent to one-third of every dollar of nonearmarked federal revenues.

We believe that such continued growth in federal deficits is the single most important obstacle to sustained, noninflationary growth of the U.S. — and indeed, the world — economy. Immediately reducing and ultimately eliminating these deficits is of the utmost importance. If these deficits are not brought under control, they will pose calamitous risks for domestic and international financial markets and for interest rates. In addition, the draining and debilitating effects of future deficits will ultimately threaten the basic standard of living and national security of our own and future generations.

A TEST OF WILL

Unless the nation is willing to make some very hard — and often unpleasant — choices, the budget deficits will continue to grow. We believe that reducing the federal deficit will prove as tough a test of the American democratic process as this nation has faced in many years. The changes in public policy that must be made are basic and wide-ranging and will touch all sectors of our society.

Getting the deficit down will challenge our nation's ability to rise above partisan and special interests and to act in the *long-term* interest of our economy and society. What we do now and during the next year will be a signal to the American people and to the rest of the world as to whether or not we are willing to take responsible, decisive, and comprehensive actions to restore control over our economic destiny.

What is needed now, and what we are recommending in this policy statement, is a national commitment to a coordinated set of short- and long-term measures that will reduce spending and increase revenues *sufficiently* to bring the federal deficit to near zero by 1989.*

The efforts by both the Administration and Congress to enact a "down payment" on reducing the deficit are most welcome. But this is far from the "full payment" that ultimately is essential. **Thus, work must also begin now on developing that "full-payment" program of successive deficit reductions to bring the federal budget into balance when the economy reaches high employment.** We urge implementation of this program as soon as possible after the election, without political vacillation or delay.

CURTAIL SPENDING, INCREASE REVENUES

We believe that the deficit-reduction program must include further policy-related actions totaling $100 billion a year by fiscal year 1987 and $170 billion a year by 1989. In our view, this can be accomplished only through a combination of expenditure restraints and revenue increases. Our specific recommendations in these areas are contained in Chapters 4 and 5. **To be perceived as fair, we believe that reductions in spending must extend to all major types of expenditures, including defense and entitlement programs. And actions to increase revenues should be linked to a forceful effort to reduce the growth in government spending.****

Any program for sufficiently reducing the budget deficit must include both measures that will have an immediate impact and those whose effects

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*See memoranda by ROBERT R. NATHAN (page 64) and JAMES Q. RIORDAN (page 65).

**See memoranda by NORMA PACE (page 66) and JOHN SAGAN (page 67).

will be felt in later years. Some of the measures that may be needed to meet the deficit-reduction goals of the next three years may not be appropriate for longer periods. At the same time, many of the measures likely to be most effective in the long run (such as better time-phasing of defense programs with long lead times, structural changes in entitlement programs, or basic tax reform) may have little or no impact on the deficit in the near term.

Accordingly, we believe it is critical to initiate *both* short- and long-term measures as soon as possible. The country must not fall into the trap of rationalizing that long-term measures are steps it can afford to put off to some distant future date. If such measures are to have a significant effect within a reasonable period, no time must be lost in getting them started.

CHALLENGE AND OPPORTUNITY

The challenge posed by the deficit problems is a very serious one. But determined and properly designed actions to reduce the deficit also present a major opportunity to achieve sustained economic expansion, reduce inflationary risks, lower interest rates, and increase the share of GNP devoted to productive investment in physical and human resources. Attainment of these goals is essential if we are to meet other important social goals such as maintaining a strong national defense and providing an adequate standard of living and greater and more equal opportunity for our citizens.

We believe that adoption of the recommendations summarized at the end of this chapter and explained more fully in Chapters 4 and 5 will go far toward fulfilling these goals.

Of course, there are no easy ways of achieving sufficient deficit reductions, and an adequate program will require some very hard choices by our society. Our statement highlights the nature of the most important of these choices, both for the near future and for the longer term, in the hope that this can contribute to and accelerate the national dialogue that is required before informed decisions on many of these choices can be made. It also recommends specific measures that should, in our view, be part of any deficit-reduction strategy.

There will be those who will say that making major changes in the way we raise and spend our public dollars is not practical or not politically feasible. This type of attitude is defeatist at best and does not take into account the growing feeling that something *can* and *must* be done. The prospect of ever-increasing deficits has focused the attention of Congress, the Administration, and the public as never before on the need for a major rethinking of public spending and on new and more equitable ways of raising federal revenues.

Now is the time to press forward. Delay and indecisiveness will only increase the risk that burgeoning deficits will eventually overwhelm even the most determined efforts to regain fiscal control.

SUMMARY OF RECOMMENDATIONS

OVERALL STRATEGY FOR DEFICIT REDUCTION

1. We recommend a deficit-reduction strategy that will:

- produce a steady, year-by-year decline in the projected deficit.
- move the federal budget on a path that will bring it into balance by the time the economy reaches high employment.
- halt the upward trend in the debt-to-GNP ratio by fiscal year 1987, with the ratio falling gradually each year thereafter. This will assure that the cost of paying interest on the federal debt will no longer be on an unsustainable upward path.

This strategy should produce a deficit of about $100 billion, or 2 percent of GNP, by fiscal year 1987 and bring the budget to near balance by fiscal year 1989.

2. The deficit-reduction program to achieve these goals should conform to three major requirements:

- It needs to involve both expenditure restraints and revenue-increasing measures.
- The program of expenditure restraints should be forceful, broadly based, and enduring. It should extend to all major types of expenditures, including defense and entitlements as well as nondefense discretionary outlays.
- Actions to increase revenues should be explicitly linked to such expenditure-restraint measures, including the types of measures recommended in this statement.

DEFENSE SPENDING

1. We favor a gradual but steady and consistent buildup in defense spending. Toward this end, we recommend that increases in defense budget authority be stretched out so as to amount to no more than 5 percent a year in real terms over the next three years.

2. We consider it essential that a slowdown in the planned pace of major weapons procurement and related outlays constitute a significant element of the actions that will be taken to hold defense spending within the recommended guidelines. This slowdown should not be accomplished by stretching out to inefficient lengths the production schedule for every new weapons system, but rather by introducing fewer weapons systems at the same time. The initiation of new programs should be time-phased, but once approved and launched, a new program should proceed at an efficient pace.

3. Much of the basic information needed for exercising more intensive scrutiny of defense spending decisions and implementation is already available. It is now time for the Executive Branch and Congress to act on this information and make the hard choices required for achieving the nation's defense objectives in the most efficient manner. (A list of relevant issues appears on pages 34 to 38.)

NON-MEANS-TESTED ENTITLEMENTS

1. Given the magnitude of the deficit-reduction task between now and fiscal year 1987, there is a compelling case for including a reduction in cost-of-living adjustments (COLAs) under non-means-tested entitlement programs in the overall deficit-reduction package.* As a preferred method of achieving this result, we recommend limiting COLAs to the percentage increase in the Consumer Price Index (CPI) less two percentage points for a three-year period.

2. There is no question that a major reform of the Medicare system and its financing will have to be initiated soon to assure the continued solvency of the system. Toward this end, we recommend the early appointment of a bipartisan national commission similar to the National Commission on Social Security Reform (Greenspan Commission) that would examine alternative options for dealing with the Medicare financing problem, recommend appropriate solutions, and seek to develop a consensus for their implementation.

3. To further minimize the possibility of another Social Security financing crisis, Congress should now consider instituting additional measures that would be triggered automatically to slow the growth of Social Security benefits in the event that the assumptions underlying current projections of future trust fund balances prove to be overly optimistic.

4. Over the long run, a wider range of options exists than in the short run for slowing the growth of Social Security and other entitlement benefits

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***See memorandum by WILLIAM C. GREENOUGH (page 67).**

in ways that will have a significant impact on the trust fund balances and on the budget deficit. Among major options which the Congress should consider in this context are:

- Applying less than 100 percent *automatic* indexation to all federal entitlement programs, with an exception for benefit recipients whose incomes fall below specified levels.
- Reducing initial benefit levels under Social Security or other entitlement programs.
- Gradually raising the normal retirement age.

5. We specifically recommend that in years when the annual average wage of workers rises less than the annual increase in the CPI, the annual automatic increase in Social Security benefits should be at the same rate as the rise in average wages. Such a rule now applies when the trust funds fall below certain levels. We believe it should apply regardless of the level of the trust funds.

6. Consideration also needs to be given to other key policy options that would yield long-range budgetary savings, such as basic reforms of the federal pay and retirement programs (both civilian and military) and of agricultural assistance programs, as well as measures to broaden the taxation of benefits under entitlement programs, restrict program eligibility, and place limits on the amounts of benefits.

MEANS-TESTED ENTITLEMENT PROGRAMS AND NONDEFENSE DISCRETIONARY SPENDING

1. Because growth in means-tested entitlement programs has already been cut back sharply, further large *overall* cuts in this area do not appear feasible. Nor, in our view, would they be desirable on equity grounds. Some additional savings in individual programs should, however, be possible through greater efficiency in program management.

2. In the long run, there is undoubtedly room for further savings in many programs that fall within the category of nondefense discretionary spending. However, the total dollar savings that might be achieved in this area can make only a limited contribution to the full deficit-reduction task because of the relatively small share of this outlay category in the overall budget and the fact that it includes various activities in which increased rather than reduced total spending may be required in the interest of sound long-term economic growth.

INCREASING TAX REVENUES*

1. In the tax area, two types of actions are urgently called for:

- An adequate near-term tax program to raise the additional revenue which will be needed if our goals for a sharp reduction in the deficit over the next two to three years are to be achieved.
- Development of a basic long-term reform of the tax system.

2. Given the need to raise revenue as quickly as possible, the near-term program to increase revenues should be based on existing types of taxes (or related forms of taxation that have previously been carefully tested) rather than on experimentation with new forms of taxation.

3. An important first step toward meeting the near-term revenue goals has been the enactment of a "down payment" revenue package in July of this year. We commend this action but urge that a determined bipartisan effort be made to adopt additional revenue measures promptly that will, together with stringent expenditure restraints, be sufficient to meet the near-term deficit-reduction target we have specified, pending the adoption of a comprehensive tax reform.

4. We recommend that the program for raising revenues over the near-term focus on the following approaches:

- **Base Broadening.** Initial priority should be given to further base-broadening measures *provided* that these measures are consistent with longer-range requirements of economic efficiency and equity.
- **Excise and User Taxes.** The deficit-reduction package should contain additional excise tax increases as well as increased reliance on user taxes.
- **Tax Indexing.** In our view, the shift to an indexed tax system is a desirable reform that removes a major inequity from the income tax system. We feel, however, that in view of the magnitude of the overall deficit-reduction task, temporary modification of tax indexing would be justified, provided that a clear commitment to the use of tax indexing over a longer period is retained. As a step that would spread the burden among individual taxpayers, we recommend limiting tax indexing to the percentage increase in the CPI less two percentage points for a three-year period. Since an unindexed tax system has particularly adverse effects on taxpayers in the lowest

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*See memorandum by ROBERT R. NATHAN (page 68).

bracket, the deferral of tax indexing should apply only to incomes above some minimum level.

- **A Temporary Income Tax Surcharge on Individuals and Corporations.*** If the expenditure reductions and revenue-raising proposals we have described are not sufficient to meet the deficit-reduction target for the next few years, it may be necessary, as a last resort, to impose a temporary surcharge on personal and business income taxes to raise the needed additional revenue. At the same time, there must be stringent provision to ensure that the surtax is, in fact, temporary and will be phased out as soon as better means of closing the deficit gap can be put in place. Adoption of a surtax should, in any event, be subject to a maximum time limit of two years. As one way to mitigate the inequities associated with a surtax, we recommend imposing the surcharge on as wide an income base as is feasible rather than on the current base of taxable income. A similar result might be achieved by using a higher minimum tax as a supplement to the surcharge.

5. We urge the Executive Branch, Congress, and the private sector to press forward with a coordinated effort to achieve a basic reform of the tax system. Such a reform should make the U.S. tax structure significantly simpler and fairer as well as conducive to economic efficiency and growth. It should, in particular, be designed to remove the current biases in the tax system that favor consumption and discourage saving and investment. The reformed tax system should also permit a better approach toward raising additional revenue than is feasible under the present system.

6. We commend the studies of longer-term tax reform options already being undertaken by the Administration and by various Congressional committees. We believe that intensive efforts by both government and the private sector are needed to build an enduring national consensus in support of a suitably reformed tax system. The immediate aim should be to assemble sufficient information on alternative possibilities for tax reform to assure that an active national dialogue on the nature and specific contents of such a reform can be initiated as early in 1985 as feasible and that this will be followed by expeditious actions to adopt and implement the reform.

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*See memoranda by JACK F. BENNETT (page 69), THEODORE A. BURTIS (page 69), OWEN B. BUTLER (page 69), FRANK P. DOYLE (page 70), DEAN P. PHYPERS (page 70), and JAMES Q. RIORDAN (page 65).

MEMORANDA OF COMMENT, RESERVATION, OR DISSENT

Page 2, by ROBERT R. NATHAN, with which WILLIAM C. GREENOUGH has asked to be associated.

This report properly calls for substantial measures to bring about a significant decline in the federal deficit. However, it is important to emphasize forthrightly that the contribution from tax increases will have to account for a major part of the reduction in the deficit.

The major thrust of this statement on deficit financing is excellent. However, it appears to emphasize curtailing expenditures somewhat more than increasing revenues. For instance, on pages 2 and 3 it is stated correctly that spending reductions must include defense and entitlement programs, but there does not appear to be the same degree of emphasis on revenue increases. Yet, on page 24 the report recognizes that further large overall cuts in means-tested entitlement programs do not appear feasible and that they would not be desirable on equity grounds. Also, at the top of page 25, it is recognized that for discretionary programs further savings may be capable of making only a limited contribution to the full deficit-reduction task. In effect, it is recognized that the curtailment in nondefense discretionary expenditures cannot contribute greatly to achieving the level of deficit reduction that is needed. We must realistically recognize that substantial tax increases will be essential if our deficits are to be reduced to manageable levels.

The present and foreseeable unprecedented huge deficits are being encountered at relatively high levels of economic activity (although far from full employment), because of two major factors. The three-year tax cut enacted in 1981 was the principal cause of the continuing massive deficits. The second major cause was the large year-to-year increases in defense spending. Reverse policies will be needed if we are going to achieve the important objectives set forth in this valuable document. Non-essential expenditures and waste must be subjected to the most probing scrutiny. It is often said that throwing dollars at problems does not bring solutions. That certainly is true of defense outlays and the many comments in this report on that subject reflect careful thought on achieving a balance between defense expenditures and national security. But the big contribution toward curtailing the deficit must come from substantially higher revenues.

Pages 2, 8, and 60, by JAMES Q. RIORDAN, with which OWEN B. BUTLER and W. BRUCE THOMAS have asked to be associated.

I agree with the need to restate our long standing policy that we should reduce the deficit to zero in years of full employment. Such an objective is meaningful, however, only if we state the maximum percentage of Gross National Product that the federal government should spend in such years. Federal government spending in years of full employment should not exceed 20 percent of GNP. The American public will not and should not subject itself to taxes that will bring government receipts above that level. A healthy economy over the long term would be more certain if we stayed well below the 20 percent ceiling.

The bulk of our current deficit problem does not result from an insufficiency of taxes. Budget receipts for the years 1980 through 1984 are estimated to average 19.7 percent of GNP. In 1984 (estimated 18.8 percent), they will be about as high as they were on average in the fourteen years prior to 1980 (18.9 percent). In 1985 budget receipts will increase as a result of the 1984 tax act. The portion of the deficit that might be covered by further increasing taxes even if we went up to the suggested 20 percent ceiling is much the smaller part of the 5.0 percent plus deficit problem.

Our tax problem is not fiscal insufficiency — it is structural deficiency. We are levying taxes in a very complex, inefficient, and inequitable manner. Many of the general tax comments in this report recognize the structural issues and restate CED policy positions for improving the situation in the long term. The report unfortunately implies that we should try to get one more tax increase out of the current sick income tax structure before we fix the overall structure itself. I disagree.

The income tax is in trouble and for good reasons. The marginal rates are too high, and as a result there are too many special provisions; it is replete with anti-savings bias and it does not effectively reach the large and growing underground economy. The public resents the fact that many who are in a position to spend heavily on consumption are taxed lightly, if at all.

The tax bills enacted in 1982 and 1984, the most recent emergency attempts to resolve the perceived deficit crisis, did not make the law simpler, more equitable, or more efficient. They increased the bias against investment.

The United States should raise a larger share of its revenue from the consumption of wealth rather than the creation of wealth. Broad-based consumption taxes are functioning reasonably well in other countries. The *next* time we change the tax law we should move in that direction rather than adding another thousand pages to an income tax that has already passed the point of diminishing returns.

We cannot improve the income tax unless we lower the marginal rates. We cannot lower the marginal rates in the face of large deficits unless we create an additional source of federal revenue. Enactment of a consumption tax coupled with reform of the income tax is not an experiment to be delayed.

Pages 2 and 22, by NORMA PACE, with which J. W. McSWINEY and W. BRUCE THOMAS have asked to be associated.

The CED report makes a significant contribution in terms of identifying the major issues in the federal deficit and providing meaningful directions in practical ways to narrow the deficit. It is important to note, however, that concerns and discussions over the effects of relatively large budget deficits have been in an active phase since passage of the Economic Recovery Tax Act of 1981. Yet despite dire predictions of impending doom, Congress and the Administration have not forged a solution: The failure does not result from a lack of sound and well thought out solutions; it reflects political realities.

The Administration believes that growth rates in the United States can be accelerated and sustained at high levels through more financial incentives to invest in job-creating ventures. According to the philosophy, the function of government is to provide a climate for growth.

Many in Congress, on the other hand, continue to focus on the redistribution of existing wealth. They take for granted that the wealth will be created, no matter what the incentives.

These fundamental differences in approach are further complicated by the defense/nondefense conflict as reflected in charges that defense outlays are rising at the expense of the needs of the poor and elderly.

Consequently, to exhort government representatives to cut spending and raise taxes is, practically speaking, to invite tax increases with no corresponding discipline in spending. The recent "down-payment" activity to reduce the budget is strong evidence of the willingness of politicians to raise taxes while actions on spending remain limp.

The only feasible approach, considering the fixed attitudes of those espousing these conflicting views, is to enact legislation that places a five-year limit on government outlays as a percent of Gross National Product. This limit should also state that *all* automatic adjustments for inflation on both spending and taxable income be eliminated. This procedure is admittedly biased against taxpayers; while it would limit inflation in government spending only to the inflation that is part of nominal GNP, payments by taxpayers to the government would rise faster not only in relation to GNP with its inflation, but also with progressive tax rates.

The proposed limitation would permit government outlays to rise no faster than GNP with a phase-in schedule to permit agencies to adjust to the requirement. Since the chances of federal spending rising slower than GNP during the next five years are nil, this constraint is the best one can hope for under the circumstances. Meanwhile, the tax collections could rise faster than GNP as individuals move into higher tax brackets. This latter part is an inequity that one can tolerate, given the unwillingness of Congress and the Administration to retreat from current spending positions without some legislated discipline.

The proposal on taxes could be considered a stop-gap measure. Since the government is involved in several proposals that may shift the tax burden to some broader taxable base, the removal of indexation from the tax base may never be taken — or needed. But it is a good bargaining chip at present.

Page 2, by JOHN SAGAN, with which OWEN B. BUTLER and W. BRUCE THOMAS have asked to be associated.

This statement describes the nature, magnitude, and significance of the nation's deficit problem and outlines revenue and expenditure actions to help solve it. But I believe that "a strong effort" to reduce the growth of government spending does not sufficiently emphasize the need for government action to reduce the deficit. I believe that the spending reductions should at least equal the magnitude of revenue increases. I would prefer that such spending cuts *exceed* the level of revenues raised from the tax increases.

Pages 5 and 45, by WILLIAM C. GREENOUGH, with which W. BRUCE THOMAS has asked to be associated.

I believe this policy statement should distinguish more emphatically between the OASDI programs of Social Security, financed by wage taxes, and the other federal programs financed by general revenues. CED on pp. 5, 25, and 38–40 recommends that COLAs under OASDI be reduced in the short term as part of the overall deficit reduction task. Only on p. 45 and in a brief mention on p. 40 does it comment that such reductions should be limited to an amount necessary for establishing an adequate margin of safety in the trust funds to assure the long-term solvency of the Social Security system.

This deserves emphasis. The OASDI programs are properly financed by wage taxes levied only on the first $37,800 of wages currently, and on no wages above that level. Any action to reduce the budget deficit significantly by, in effect, diverting dedicated Social Security wage taxes would be, I believe, a serious mistake. This would have the same effect as legislating a regressive tax only on wages, and only on wages up to a certain level, to support general governmental expenditures including military. Polls show that younger workers in America are already skeptical that Social Security will be available when they retire.

For fifty years, labor, management, Social Security experts, actuaries, economists, Congresses, Administrations, and the CED itself, have fought against financing OASDI through general revenues, believing that such action would change the entire nature and acceptance of the program. It would now be, I believe, a much worse error to turn this upside down, and support general governmental expenditures through the Social Security wage tax.

The CED has proposed a number of improvements to increase the financial stability of the Social Security program in its original policy statement *Reforming Retirement Policies,* September 1981, and in its statement *Social Security: From Crisis to Crisis?,* February 1984. Some of the earlier recommendations were incorporated into the Social Security amendments of 1983. The recommendations covering benefit levels, indexing, retirement age, and wage taxes are important and should be considered on their own merits, separate from the general budget deficit situation.

Page 7, by ROBERT R. NATHAN, with which FRAZAR B. WILDE has asked to be associated.

The nature and composition of the tax increases needed to achieve a large reduction in federal deficits are far too serious to be dealt with in such brief manner. The words "base broadening" and "excise and user taxes" have all kinds of implications and mean different things to different people. We do need tax reform, but reducing the relative role of income taxes and increasing the relative share of consumption taxes is a very complex and challenging subject. I believe that even these brief comments carry connotations which can be misleading and harmful. Therefore, this otherwise excellent report should call for very substantial revenue increases, but the composition of these increases should be dealt with much more fully in another CED report.

Pages 8 and 60, by JACK F. BENNETT, with which OWEN B. BUTLER, EMILIO G. COLLADO, RODERICK M. HILLS, JAMES Q. RIORDAN, and FRAZAR B. WILDE have asked to be associated.

There is no practical way to guarantee that an income tax surcharge would be temporary. There is no likelihood that a surcharge would be enacted in a form which did not intensify the inequities and disincentives of present tax law. Rather than recommending such a backward step away from desirable reform of our tax system, the CED should be recommending that, if it is decided that additional revenue must be raised, the Congress should begin reform by building on extensive European experience and enacting a low-rate national value-added tax in 1985.

Pages 8 and 60, by THEODORE A. BURTIS, with which JAMES Q. RIORDAN, W. BRUCE THOMAS, and FRAZAR B. WILDE have asked to be associated.

The current growth in the economy and the resulting increase in individual and corporate tax receipts have reduced estimates of federal borrowing and deficits. While the deficit remains a real problem, a near-term tax increase to offset the deficit is the wrong policy direction, and an effort to hit an illusive target. A decrease in the rate of growth of federal spending could bring the deficit down to manageable levels and is the primary policy that should be pursued at this time. Any major tax increase would likely coincide with the anticipated downturn in the business cycle resulting in the possibility of yet another recession. If Congress is unable to address the rate of growth in federal expenditures due to the deep division of its members on defense versus nondefense spending, then a "Blue Ribbon Commission" to address this problem in 1985 would be appropriate. While a proliferation of commissions should not be the solution to every problem, the Grace Commission has established valid guidelines and commissions have been politically effective.

Pages 8 and 60, by OWEN B. BUTLER, with which WILLIAM C. GREENOUGH, W. BRUCE THOMAS, and FRAZAR B. WILDE have asked to be associated.

While I agree that increased revenues will have to be an integral part of our deficit reduction efforts, I disagree with the proposal to impose a temporary income tax surcharge on individuals and corporations.

Page 50 of the policy statement eloquently describes the economic distortions and counterproductivity of the existing income tax system. We should not exacerbate this problem by resorting to a surcharge. Rather, we should begin reform by imposing a modest consumption tax (sales tax, value-added tax, or excise tax) as a new source of revenue to augment existing sources. While this will not achieve tax reform, it will at least begin to move us in the right direction.

Pages 8 and 60, by FRANK P. DOYLE.

I believe that imposing the surcharge on as wide an income base as feasible will produce adequate revenue in a more equitable manner while avoiding the counterproductive effects of the minimum tax on desirable activities encouraged by tax preferences.

Pages 8 and 60, by DEAN P. PHYPERS, with which RODERICK M. HILLS has asked to be associated.

In the short term, if the federal government finds the sum of expenditure reductions and revenue-raising proposals insufficient to reduce the anticipated budget deficits and seeks to raise other revenues, it should not do so by means of a surtax on the existing corporate income tax which merely perpetuates existing inequities. Rather, to the extent that additional revenue is required, it should seek taxes on income which is currently escaping tax, such income as would be generated by an increase in the minimum tax.

There should be limits on the extent to which one's share of the tax burden can be reduced by preferences. The present corporate minimum tax on preferences accomplishes this goal in part, but only in part. However socially desirable investment in plant and equipment, or exploration for new energy sources, or similar expenditures may be, all corporations and individuals with sufficient incomes should devote at least part of their economic profits to financing the government from which all benefit.

Taxes, even temporary taxes, should fall roughly equally on all. The incentive to enter into uneconomic arrangements merely to avoid income tax should be reduced. Some action must be taken, other than a mere surtax on existing taxes, to broaden the base in the process of serving the primary function of fair and efficient raising of needed revenues for the functions of government.

Page 14, by NORMA PACE, with which J. W. McSWINEY and W. BRUCE THOMAS have asked to be associated.

My studies clearly indicate that the impact of government policies on interest rates and economic activity result from both government spending and taxing — not the deficit alone. Consequently, concern over deficits alone will lead to solutions that can backfire — just as the recent federal policies which provided tax cuts without sufficient offsetting spending contractions created the "structural" deficits.

Government spending stimulates consumption — its impact is across the board on all income groups, whether payments reflect means-tested entitlement programs, non-means-tested entitlement programs, defense outlays, or increased government wages. Consequently, higher outlays, with or without deficits, will stimulate the economy. By increasing the demand for goods and services, these outlays also increase credit demands.

Federal taxes affect both spending and savings. But if one considers capital investment a form of savings, then tax reductions increase savings much more than spending. In the National Income Accounting procedures that we use, however, capital investment is a part of business spending; consequently, the business tax cuts enacted in 1981 (partially rescinded in 1982) which stimulated business spending are considered to have encouraged more spending than savings. But looked at from Mars, the nation has saved much more with the tax cuts because they increased both physical and financial assets.

If increased taxes were to contribute half or more to the desired reductions in deficits, as some propose, spending for capital goods (a long-term savings) as well as financial savings by both business and individuals would be reduced. What would we accomplish by that policy?

Imposing limits on spending as a percent of GNP, accompanied by appropriate tax policies, will provide a solution that will continue the job-creating programs needed for long-range sustained growth; it would also provide the large margin needed to take care of the increasingly volatile international climate.

Page 14, by ROBERT R. NATHAN, with which FRAZAR B. WILDE has asked to be associated.

If we are going to avoid serious distortions in the economy and achieve balanced economic growth without inflation, we must recognize that fiscal policy alone will not do the job. Major reductions in the federal deficit will certainly represent an important step in the right direction. However, we must also look at monetary policy and at specific anti-inflation programs.

What we have today is an unprecedented expansionist fiscal policy. Deficits are almost inevitable in recessions and they do serve to initiate and enhance recovery. The vigorous recovery has certainly been the consequence of the large deficits. But current and prospective large deficits have led to highly restrictive monetary policies. We have an unprecedented level of interest rates for this stage of economic recovery. High interest rates result from tight monetary policies which are justified on the basis of the large deficits. The Federal Reserve Board regards itself as the lone force fighting inflation. Rising interest rates will dampen the demand for housing and other debt-oriented consumer goods as well as capital formation and will cut further into our already depressed export markets. We could go back into a recession and that would lead to even larger deficits. So, the war on inflation will be fought by suffering another recession.

Measures other than fiscal and monetary policies must all be pursued to assure balanced economic growth. This is not the place to develop such a program, but it needs to be noted. We must act urgently to get the deficits under control, but that will not be the only task needed for balanced growth.

Page 30, by WILLIAM S. EDGERLY, with which W. BRUCE THOMAS has asked to be associated.

The case for stretching out the defense buildup depends on a questionable assumption about national security requirements. While the statement mentions the need for current military readiness, it implies that in the near term the nation is only faced with limited local conflicts. In fact, the proposed elimination of weapons programs could make a major conflict more likely, because the United States would be perceived by the Soviet Union as less prepared, less determined, and more susceptible to pressure. If such a conflict did occur, the elimination or postponement of weapons programs would prove to be false economy.

Page 40, by RAFAEL CARRION, JR., with which OWEN B. BUTLER, RODERICK M. HILLS, J. W. McSWINEY, W. BRUCE THOMAS, and FRAZAR B. WILDE have asked to be associated.

I strongly oppose the use of automatic cost-of-living adjustments (COLAs) in either the private or public sectors. COLAs are an engine of inflation that should be completely eliminated.

Now that we have managed to control inflation, is the time to do it. This would not preclude future adjustments on a selective basis from year to year, depending on circumstances at the time, but not automatically as it is now.

Maintaining a sound dollar should always be a prime objective.

Page 40, by ROBERT R. NATHAN, with which FRAZAR B. WILDE has asked to be associated.

Given the fiscal crisis, it is essential that most groups in our society make some contribution to reducing the federal deficits. In normal times it would be inappropriate and unfair to curtail the real buying power of those who are receiving Social Security benefits. Asking our senior citizens to absorb two percentage points out of the percentage increase in Consumer Price Indexes for a three-year period will impose added hardships on many elderly who rely solely or heavily on those monthly checks. It does mean that those receiving Social Security will have a drop in the *real* value of their benefits by about 6 percent over the next three years.

Over the longer run, retirement benefits should not be reduced in real terms. The Social Security beneficiaries have paid the payroll taxes for many years and those taxes are as regressive as any taxes now levied. Also, the new law provides for taxing half of the old age retirement benefits for those with gross personal incomes exceeding $25,000. A three-year temporary COLA reduction of two percentage points is all that should be contemplated.

Chairman **Domenici**. Governor Snelling.

STATEMENT OF HON. RICHARD A. SNELLING, CHAIRMAN, PROPOSITION ONE

Governor **Snelling**. Mr. Chairman, members of the committee, with your permission, I would like to depart from my text, which you have, and just speak to you about a problem, on behalf of Proposition One, a nonpartisan organization dedicated to the notion that if the people understood the problems with the deficit and understood the solution, that they would back the Congress in doing at once the things that need to be done.

As you pointed out, Mr. Chairman, I was here for the early testimony, so I want to start off by saying I am a dues-paying member of the American Association of Retired Persons; that in my lifetime, I have paid tons of dues to chambers of commerce, State, local, and national; that the members of the board of directors of Proposition One are active members of the National Association of Manufacturers, the chamber of commerce, they are homebuilders, they are realtors.

I want to suggest, as a matter of fact, that part of the problem really is the flip side of the advocacy system that we use in this country. And I think every one of us would agree it is a wonderful system. But when organizations come together in Washington to represent the interest of some group, they really do become dedicated to the interests of that particular group, and it is very hard for them to volunteer that they will give up early on something which is important to them, even in a debate; where individually, their members may very well understand that the solution is not going to come about unless everybody gives something.

One of the actions of Proposition One presently is asking you and your colleagues to sign a pledge—you have a copy of that pledge in front of you—which does set forth our plan of action. And I might say this may be the only document which has ever existed which has the support of former President Ford and former President Carter, which has been agreed to by both Dr. Walter Heller and Dr. Alan Greenspan, and which finds favor with the chairmen of the board of some of the largest companies in this country, and with a number of union leaders and advocacy groups here in Washington.

ZERO OPERATING DEFICIT BY 1989

And our belief, in a nutshell is, No. 1, that the goal has to be a zero operating deficit sometime in the reasonable future. And the date we pick is 1989. It is not as though we think there is any magic in zero, or for that matter, in 2 percent or in 1 percent. It is that, as you know, this is a structural problem, and that the longer it goes on, the greater the interest component. And if we do not get the deficit down to zero, then increasingly over the years, that interest bill is going to grow. Someone said our children are going to pay. Hell, we are going to pay. By 1989, as someone has pointed out, that is going to be $235 billion up from $130 billion this year. So we really do have to get to zero.

FIND REASONABLE EQUAL PORTIONS TO RESTRAIN BUDGET

The second fundamental notion of our group really is a steal from Willie Sutton who was asked why he robbed banks, and he said, "Well, that's where the money is." Our notion is that you are just not going to attack a $250 billion deficit without going to where the money is, and that really means, for all kinds of reasons, mathematical and political, that we are going to have to find reasonable equal portions by restraint in the military budget, by restraint in the domestic budget, and through revenue.

Our feeling very strongly is that if you rule out any of those, or even if you approach the problem one step at a time, as so many people have suggested here today, that you get into a trap from which you cannot escape. You can say, well, we are going to talk only about domestic spending, for example. Then clearly, the proposals that have to be made are draconian; they do bring the concept of restraint well past restraint to the point where the proposals have very little support. It is a mistake not to start from the beginning, understanding that we are only going to succeed if we address the problem by finding reasonably equal proportions from each of the places where they may be found.

To be very specific, if by 1989, we were to be spending something like $60 billion less than is now planned, for military spending, and something like $60 billion less than is now planned in the domestic arena, and we were to find something like $60 billion more in revenues than present systems would provide, we would among other things also have about a $30 billion lesser interest bill, and the budget would come reasonably in balance.

In case that sounds familiar, that is the proposal of Dr. Martin Feldstein. It is really very close to the proposals that are offered by others who have appeared before you who have studied the situation.

And in that event, although all of the actions would be painful and would be difficult, no single one of them would be so severe as to be beyond support by the American people. Perhaps the most controversial is the revenue suggestion. I need to point out that that would still only represent about a 6-percent increase overall, over the 4 years, from present levels, and would be about 25 percent of the tax cuts which were given a few years ago.

Mr. Chairman and members of the committee, we think perhaps the toughest thing to tackle is the concept that it is possible not to have a tax increase when you run a $200 or $250 billion deficit in good times and in peace. That really is an intellectual fallacy. It suggests that if people do not send you the bill, you have not incurred the expense. We believe that the American people are going to get the bill for this year's deficit, and they are going to get it for last year's deficit, and they are going to get it for next year's deficit, and they are going to get it when they can least expect it and when they can least afford to pay it. The tax exists. All that has not happened so far is that the bills have not been sent out.

So we think it is reasonable to suggest that America must order for itself what it needs, and it must pay for what it orders. That is essentially the concept of Proposition One.

PEOPLE WILLING TO PAY THEIR FAIR SHARE

You know, we believe, after talking to many Members of the Congress, that if there was a provision for a secret ballot in the Congress—and we know why there is no provision for secret ballots—but we believe that if you were to have a joint session tomorrow and have a secret ballot, that you folks would address this problem, and you would address it essentially along those lines. But I also want to tell you that there are a lot of people in the United States who do understand the solution.

Mr. Chairman, I have just returned from 60 days of traveling throughout this country. I have spoken in the last 60 days to something like 40 million people, on all their radio national talk shows almost that there are, and television shows, and call-ins. And what the people say over and over again is that they do understand the severity of this problem, they do understand its threat to our economic future, and that they are willing to pay their fair share. And I would support, and our committee would support, and we believe the American people will support, the Congress taking action promptly which deals with the problem in all of its facets and which attempts to assess a fair share to all of the people of the country. If we do not pay our fair share now, we are all going to pay an awful share in the economic calamity which almost certainly would result from the failure to deal with this problem.

Chairman DOMENICI. Thank you very much, Governor.

[The prepared statement of Governor Snelling follows:]

PROPOSITION ONE
Stop Deficits Now

Governor Richard A. Snelling
Chairman
The Honorable Jimmy Carter
The Honorable Gerald R. Ford
Co-Chairmen, Advisory Board

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THE DEFICIT PROBLEM

The Honorable Richard A. Snelling
Chairman, Proposition One

Statement before the Budget Committee
of the United States Senate

February 22, 1985

First of all, I would like to thank you, Mr. Chairman and the members of the Budget Committee for the opportunity to appear before you. In my view, your work is vital to the future of the United States, and I therefore welcome this opportunity to testify.

Many of you know me from my four terms as Governor of Vermont and as Chairman of the National Governors Association. Yet you may be unaware of my new role, that of Chairman and founder of Proposition One. We are a nonprofit, bipartisan membership organization of concerned citizens from many constituencies. Former Presidents Gerald Ford and Jimmy Carter are honorary co-chairmen of this effort. Also among those on our distinguished Advisory Board are nine former cabinet secretaries, three former Chairmen of the President's Council of Economic Advisors, and thirty-two prominent economists and business leaders. Our sole purpose is to educate and inform the American public of the deficit danger to create a supportive environment in which the Congress and

Proposition One is a tax-exempt, non-profit 501 (C)(4) organization.

the Administration may act to promptly resolve the deficit crisis without fear of political retribution.

I have no intention of taking the committee's time or any part of my five minutes telling you that the deficit problem poses a serious threat to our future. I do not want to cover old territory or rehash what many organizations and individuals have no doubt told you several times before. If any one of the committee members does not believe that the deficit poses a serious threat to America's future, I would be happy to answer any specific questions you may have concerning the implications of continuing the status-quo in our spending and taxing policies.

Instead, let me briefly state that Proposition One believes that if the Congress fails to eliminate these deficits, we will eventually be forced to contend with the problems of a "fluttering-stuttering" economy which will lead us down the path of long-term economic stagnation. If we permit this to happen, the ability of the economy to support the essential elements of the American dream will be dramatically restricted, and our children and our children's children will not have the same opportunity for prosperity that we all enjoyed.

Similiarly, I am not going to tell you that I have a painless solution to the deficit dilemma. The very fact that the problem still exists bears strong testimony to the fact that there are no easy solutions. I believe you would have found one by now if there were one to be found. Anyone who appears before you who says he or she has the "answer," and it is simple and without sacrifice, does not really have a viable solution to the problem.

Mathematically, the sheer size of the deficits we are now experiencing and those that are projected for the rest of the decade mean that all of the deficit solutions which are currently "in vogue" will not be able to bring about the resolution of the problem.

Obviously, the entire $250 billion needed to balance the budget could not come from just cutting the budget for the military. If we tried, the resulting erosion in the strength of our armed forces would threaten national security. Certainly, the American people would not allow the Congress to increase our vulnerability to attack by hostile forces through such a deficit reducing strategy.

Secondly, relying solely on cuts in the domestic budget to eliminate the deficit threat will likewise be unsuccessful. Although this option seems to be popular at the present time, because of contracts and commitments made in previous years, there simply is not enough meat on the bones of discretionary non-defense spending programs to do the job, especially on the heels of the estimated $63 billion in cuts (in 1984 dollars) already achieved during the first four years of the present Administration.

Although many committee members are already aware of the shrinking size of the non-discretionary domestic budget, Proposition One members, nevertheless, want to go on record as saying that the total cost of all domestic spending programs, other than entitlements and interest, today amounts to only 80 percent of this year's deficit. That means, that if defense spending, Social Security, interest on the debt and other non-negotiable contracts were left untouched, and everything else in the federal government were stopped cold, the nation would still be in the red.

Thirdly, although possible in theory, we also cannot accomplish the job of eliminating the deficit by exclusively raising revenues. To do so would result in a tax burden well in excess of the all-time record of 20.8 percent of GNP established in 1981. Such a tax onus would stifle incentives for savings and investment, and would limit productivity gains which are so vital to increasing our future living standards.

Moreover, combining only two of the three will likewise result in failure. Just raising taxes and cutting the defense budget conspicuously failed last fall to attain the necessary majority in the Congress to be enacted. Relying on a combination which includes just cuts in the domestic budget and revenue measures will also meet a similiar fate.

The conclusion of our organization is that the only credible deficit elimination plan will necessarily require a balanced approach to the problem, including roughly equal proportions of cuts in domestic spending levels, reductions in planned outlay levels for the military and increased revenues. We believe anything less than this balanced three-pronged attack on the deficit will fail to attain the needed majority in the Congress to get a plan enacted.

Our message to you is to please act promptly, because the window of opportunity is vanishing. Each year we wait means that the deficit becomes further imbedded in the economy and the task becomes even larger, while the number of available options diminish.

In addition, please use all three mechanisms at your disposal. Modest revenue increases, enacted as part of a package which includes both restrained domestic and defense spending levels, would not only be of the size necessary to move toward a balanced budget by the end of the decade, but would also represent a compromise between the conflicting views of the adequacy of defense and domestic spending plans.

Furthermore, charging the American public for the "full cost" of what the government is spending may also result in greater gains in expenditure restraint than is presently possible when the electorate is receiving more than they are paying for. I am encouraged by the fact that the national habit of "tax and spend" has at long last been broken. But the war is not over. The task before us is to come up with an alternative to the even more disastrous policy of "borrow and spend." By budgeting for deficits, Proposition One believes we are simply shifting our present tax burden onto future generations, but with a huge net interest premium.

The Proposition One organization is distinctly different from other organizations which have appeared before you. Many of our members are also members of other groups. We are made up of individuals who call themselves Republicans, Democrats, small businessmen and women, union members and realtors, among many others.

We have all come together in agreement that much of the deficit problem centers on the system of advocacy within the Washington establishment, where groups with a common but narrow interest assemble formidable organizations, and concentrate their efforts on solutions to problems which protect their interests. Proposition One represents a much needed umbrella organization committed to the concept of shared sacrifice. We believe that if each of us gives up a little now and the problem is resolved before it becomes a crisis, we will save ourselves from having to sacrifice much more later on.

Over the past month, I have traveled to twenty metropolitan areas in fifteen states. I have reached nearly twenty-five million Americans with the Proposition One message. Mr. Chairman, my experience has taught me that there are many Americans who already fear these deficits and are willing to support those members of the Congress who will take necessary steps to eliminate the deficit threat. They are citizens who understand the near and long-term implications and consequences of these deficits and are willing to pay their fair share. The problem is we need more of them.

That is what Proposition One hopes to achieve. We are striving to convince all Americans that the risk of economic failure justifies a willingness to pay their part of a fair and just solution. Many believe the public will come to have this sufficient understanding only after a serious crisis is in progress.

But our faith in democracy leads us to reject such a notion. We believe the public can be made to see that we must act quickly before it is too late, even if the wise and necessary action the majority must support is self-sacrifice which is equally shared.

Thank you.

Chairman DOMENICI. Senator Chiles.

CONSIDERING TAX REVENUES BEFORE SPENDING CUTS WILL BE DIVERSIONARY

Senator CHILES. Mr. Chairman, I know we are running late.

I hear a similar message coming from everybody.

Mr. Kilpatrick, I like the way your statement is written. You ask a question and then answer. The question is if we saved $50 billion the first year, and then we came to you and had a package that would come up with spending down to 2 percent by the third year, you thought the companies of the Business Roundtable would support that.

I do not read the statement to say that the last 2 years all had to be done in the spending. Does that mean there is some room in that statement for revenue? I know the Roundtable does not like to talk about that, kind of like Democrats do not like to talk about if, either, after we got our brains beat out in the election.

Mr. KILPATRICK. Mr. Chiles, the Roundtable clearly favors doing our very best as a nation to achieve the goals of $50 billion reduction the first year, down to 2 percent of GNP in fiscal year 1988 by a spending reduction. And we believe that that, frankly, is possible, if you do the right things on the defense program and the entitlement programs, and that you have a freeze plus selective cuts elsewhere—I am not talking about all the cuts that are in the President's budget.

Now, as to would the Roundtable support tax increases beyond that, I cannot say specifically. It would depend on what the total package was and what the circumstances were at that time.

I do believe strongly that to consider tax revenues, tax reform, or whatever we want to call it, until the spending side has been addressed will be diversionary at best, and my strongest urging is that we deal with the budget and only then turn ourselves to whether we need any sort of revenue-raising measures.

Senator CHILES. Governor Snelling, I want to compliment you on your statement and also on the stands you took when you were Governor and chairman of the Governors' Conference. You have always been one that spoke out on the deficit and strongly on the need to do something about it.

And I agree with you that the tax is really there. I think it is there today, not just in the future. I think it is there in the interest rate we are paying. So our people are paying a tax right now. It is the abnormally high real interest. I think it is the tax we are paying there, it is the trade deficit we are paying. We are paying it right now.

BUDGET CUTS HAVE TO BE MADE

Chairman DOMENICI. I am sorry that we are going to cut the hearing short. I think we understand, and we are very appreciative of your coming and appearing before us.

It does appear to me that all of your groups have contributed immensely to solving this problem. Although there is diversity, obviously, among the solutions, there is one serious, significant thing that is consistent, and that is that we have got to reduce the deficit.

We hear the economists who are frequently rather fuzzy about how much longer we can live with these kinds of deficits. We heard yesterday, I think, some theory about how things seemed to be better than we ever expected, and maybe they can continue.

I would suggest that you do not need any preaching. But if you look at the past cycles of America's economy, unless you believe that we are living in a new era, you probably expect we are going to have a downturn one of these days. I am hopeful the business cycle will be much longer than it ever was. But I do suggest if there is any temptation to say it might go on, that you look at the CBO's testimony on where the deficit will be under current policy if we were to have a serious downtown. I think even the economists who testified yesterday, two of whom were not too sure that deficit reduction was urgent, will say, "Yes," when you ask them, "Do you think we will have another recession one of these days?" If you leave current policies in effect, that deficit will be between $350 and $450 billion, and that is using current dollars, that is pretty frightening.

Some of you have used previous history to tell us how large this deficit is. "In 1972, the full budget of the USA equalled the interest payments of today," and those similar kinds of comparisons.

I do want to say that I do not see anyone moving away from their responsibility on this committee. I think they are probably like you all. You have a solution, Dr. Molander, and that prompts you to say, "It is serious enough so I have got a solution. Means-tested programs ought to be included and put Social Security and Medicare and all the pensions on the table." That is one of the hallmarks of your domestic proposals, and clearly, nobody up here will join that, I do not think—maybe one person—but they still agree with you that we have to get it done.

A number of them agree with you, Mr. Kilpatrick, that we ought to go after all of the things, including defense, and do all of the cuts first. There are some that say do both cuts and taxes together, even if you sequence them. Our job is a tough one, because we have got to put a package together that can get the votes. And then we have the President, who cannot be ignored. I mean, obviously, he just won an election, and he is President of the United States. It sure would be nice if we could produce a resolution, with reconciliation, that he could agree with. I do not know how we are going to do that, because our committee is just about like you all, maybe split a little differently, so it will be tough.

We appreciate your help, and we will be in touch with you as we move through, because some of you may be able to support what we produce, even if it is not exactly consistent with the recommendations of your groups.

Senator Chiles?

Senator CHILES. I wish we could take this panel down to Pennsylvania Avenue.

Governor SNELLING. We are available.

Chairman DOMENICI. That is not the problem he refers to.

Thank you very much.

[Whereupon, at 12:20 p.m., the committee was adjourned.]

AFTERNOON SESSION

The committee met, pursuant to notice, at 2:16 p.m., in room SD-608 Dirksen Senate Office Building, Hon. Pete V. Domenici, chairman of the committee, presiding.

Present: Senators Domenici, Kasten, Quayle, Chiles, Hollings, Sasser, and Riegle.

Staff present: Stephen Bell, staff director; and Gail Fosler, chief economist.

For the minority: Richard N. Brandon, staff director; and John Hilley, senior economist.

OPENING STATEMENT OF CHAIRMAN DOMENICI

Chairman DOMENICI. The hearing will please come to order.

I would like to welcome our last panel of the day. Dr. John (Jack) Albertine, president of the American Business Conference; Mr. John Sloan, president and chief executive officer for the National Federation of Independent Business; and Mr. Van P. Smith, chairman and president of the Ontario Corp., and chairman of the board of the chamber of commerce.

Gentlemen, we have heard from several business and business supported Government policy research groups this morning. There was a broad commitment to a substantial deficit reduction package, generally on the spending side of the budget. Indeed, some believe that the President has not gone far enough.

I hope that you will share your views on the appropriate goals that this committee should set for itself and just how, in your view, we should go about achieving those goals. This will be a difficult process, but support from groups such as your own will be instrumental in helping us succeed.

Senator Hollings, do you desire to make any opening remarks?

Senator HOLLINGS. No. I would like to hear these gentlemen.

Chairman DOMENICI. Let us proceed. Dr. Albertine, you are first.

Dr. ALBERTINE. Thank you, Mr. Chairman. I would like to submit my testimony for the record.

Chairman DOMENICI. It will be made a part of the record.[1]

STATEMENT OF DR. JOHN M. ALBERTINE, PRESIDENT, AMERICAN BUSINESS CONFERENCE

Dr. ALBERTINE. I would simply summarize a few points on behalf of the American Business Conference.

First, Mr. Chairman, Senator Hollings, we believe that this is the finest recovery since World War II. This is the most balanced recovery we have had since World War II. The overwhelming majority of the economics profession was absolutely wrong about the quality and the character of this recovery.

The economics profession had forecast that the recovery would be very weak, particularly in 1984. Despite the enormous pent-up demand for capital goods resulting from the lack of investment during the 1970's most economists thought that funds would not be available to finance increased purchases of capital goods.

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[1] See p. 533.

That has turned out to be absolutely incorrect. In the third quarter of 1984, the seventh quarter of this recovery, business fixed investment as a percent of gross national product was 20 percent higher than in any quarter of any recovery since World War II.

This has been the most investment dominated recovery since World War II. This is good news for the future of the American economy, because we are creating jobs not just by producing current consumption but by increasing the capacity to produce future consumption.

The question, Mr. Chairman, is where did the money come from to finance this boom in investment in 1984. The answer is that part of it came from capital inflows from abroad because of the high foreign currency price of the dollar, but most of it came from the concurrence of the reduction in inflation which occurred in 1982, 1983, and 1984 with the liberalization of depreciation and other aspects of the 1981 tax act.

ERTA gave corporations improved cash flow and they invested it in new technology.

FEDERAL DEFICIT BAD PHENOMENON FOR VARIETY OF REASONS

Now, the only cloud that we see on the horizon for the continuation of this recovery, Mr. Chairman, is the growing Federal deficit. We think that the Federal deficit is a very bad phenomenon for our country for a variety of reasons.

First, it transfers resources from the private sector to the public sector, and we happen to have a bias. We think that in general terms the private sector utilizes resources more efficiently and more effectively than the public sector does. This is not because there are smarter people in the private sector, but because the incentives to reduce costs and maximize output are stronger in the private sector.

So the deficit is bad simply because it moves resources from the private to the public sector.

Second, the deficits are bad because they constrain future generations. They are going to add to the tax burden of future generations. They are going to make spending decisions at the Federal level very difficult for future generations, and we think it is intolerable to add this kind of burden to our children and our grandchildren.

Third, Mr. Chairman, there is no question that these deficits at some point are going to put the Federal Reserve in a box.

Senator HOLLINGS. By when would you guess?

FED IS GOING TO BE FACED WITH TREMENDOUS PROBLEM

Dr. ALBERTINE. I would say, Mr. Chairman, that we will have a good 1985. I would not predict that it would be a good 1986, unless we do something on these deficits. I think the Federal Reserve will be hard pressed to continue to finance this recovery much into 1986, unless something is done up here with respect to the deficits. At some point, the Fed is going to be faced with a tremendous problem of whether to continue to monetize a huge portion of the deficits, which will be inflationary down the road, or to constrain the rate of growth of the money aggregates, which could topple the economy into a recession.

Mr. Chairman, there are no cuts that you all could envision that we would not support at the American Business Conference. Absolutely no cuts. We support the President's budget. We would hope that that would be the minimum that could be done. We would like to see more done. There are no cuts in any programs that this committee could undertake that we would not support.

We hope that what is done would be across the board. We would like to see, obviously, more done in the area of defense spending. We would obviously like to see something done about the entitlement programs. We know how difficult that is.

But there are no cuts that the American Business Conference will not support.

We think that if the Senate and the House can make some progress this year in restraining the growth of spending, and eliminating a number of programs, it will have a very positive effect on the slope of the expenditure curve in future years. Moreover, we think that will give a lot of aid and comfort to the Federal Reserve to continue to finance this recovery.

We think this recovery, in fact, can go on for the rest of this decade. The fundamentals in this economy are quite strong. We think that if you look at tax policy in the 1980's it is much better with respect to savings and investment than in the 1970's.

Regulatory policy is better. Certainly energy prices, and the effects that those energy price reductions have on capital formation are very positive. Obviously, the reduction in the rate of inflation is very positive with respect to capital formation.

So, we think that we can continue to have a very strong investment sector for the last half of the 1980's with relatively slow growth in a labor force. We think capital/labor ratios can be very strong. Productivity performance can be very good and growth can continue.

But it is essential that the Congress take some action soon to demonstrate to the Federal Reserve and to the financial markets that we are serious about trying to get this deficit under control.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much.

[The prepared statement of Dr. Albertine follows:]

TESTIMONY
OF
DR. JOHN M. ALBERTINE
PRESIDENT OF THE AMERICAN BUSINESS CONFERENCE
BEFORE THE
SENATE BUDGET COMMITTEE
FEBRUARY 22, 1985

GOOD AFTERNOON.

IT'S A PLEASURE TO BE HERE TODAY TO DISCUSS THE OUTLOOK FOR THE FEDERAL BUDGET AND ITS EFFECT ON OUR ECONOMIC FUTURE. TODAY, OUR ECONOMY IS WELL ON ITS WAY TO A THIRD STRAIGHT YEAR OF ABOVE-TREND GROWTH. WHILE I DOUBT THAT THIS YEAR'S ECONOMIC GROWTH WILL BE SO RAPID AS TO BREAK LAST YEAR'S RECORD, I STILL EXPECT IT TO EXCEED THE AVERAGE FOR THE POST-WAR PERIOD.

WHEN THE ECONOMY SKIDDED TO 1.6% REAL GROWTH IN THE THIRD QUARTER OF LAST YEAR, MANY ECONOMISTS PREDICTED THAT IT WOULD CONTINUE TO FLATTEN OUT IN THE FOURTH QUARTER AND WOULD SLIDE

INTO A RECESSION IN EARLY 1985. HOWEVER, WITH A LITTLE PUSH FROM THE FEDERAL RESERVE, THE ECONOMY REBOUNDED IN THE FOURTH QUARTER. THOSE ECONOMISTS WHO WERE SO QUICK TO PREDICT A RECESSION WERE ALSO QUICK TO REVISE THEIR FORECASTS UPWARD.

THE RECOVERY IS STRONG AND WILL CONTINUE TO BE STRONG, BECAUSE IT HAS BEEN BUILT ON A FOUNDATION OF ROBUST BUSINESS INVESTMENT. WE HAVE GROWN BY INCREASING OUR CAPACITY TO GROW. THE FACTORS THAT CONTRIBUTED TO OUR POOR PRODUCTIVITY PERFORMANCE IN THE 1970'S -- A DECLINING RATIO OF CAPITAL TO LABOR, OVER-REGULATION, UNSTABLE ENERGY PRICES, AND ANTI-INVESTMENT TAX POLICY -- HAVE BEEN CORRECTED. TODAY, THERE IS ONLY ONE DAM IN OUR ECONOMIC RIVER, AND THAT IS THE FEDERAL BUDGET DEFICIT.

OVER THE LAST FEW YEARS, THE DEFICITS HAVE GROWN AT A FRIGHTENING PACE. THIS TREND MUST BE REVERSED. MEGA-DEFICITS TRANSFER RESOURCES FROM THE PRIVATE SECTOR, WHERE THEY ARE USED EFFICIENTLY, TO THE PUBLIC SECTOR, WHERE THEY ARE ALL TOO OFTEN

SQUANDERED. IF WE DO NOT TAKE PROMPT ACTION TO REMEDY THE DEFICIT PROBLEM, WE WILL LEAVE OUR CHILDREN A LEGACY OF HIGH TAXES, SLOW GROWTH, AND FEWER ECONOMIC OPTIONS. BUT, WE SURVIVED AN ECONOMIC DUNKIRK AT THE BEGINNING OF THE DECADE, AND WE BROUGHT OURSELVES BACK FROM THE BRINK OF ECONOMIC STAGNATION. NOW WE MUST DO IT AGAIN.

THE DEFICITS HAVE BECOME A CANCER ON THE AMERICAN ECONOMY, GROWING ALMOST OUT OF CONTROL. LIKE ANY OTHER TREATMENT FOR CANCER, THE REMEDY FOR HIGH DEFICITS IS NOT PAINLESS. IT IS LIKELY TO AFFECT SOME HEALTHY CELLS IN ADDITION TO THOSE THAT ARE DISEASED. HOWEVER, I DOUBT IT WILL TAKE US LONG TO DISCOVER THAT THE CURE IS MUCH LESS WORSE THAN THE DISEASE.

YOU CANNOT BE TIMID WHEN YOU SEEK CUTS IN THE FY1986 BUDGET. WE SUPPORT A FREEZE PLUS WHATEVER ELSE YOU CAN BRING YOURSELVES TO CUT. WE LOOK UPON THE PRESIDENT'S $50.8 BILLION IN CUTS AS THE MINIMUM THAT WOULD BE ACCEPTABLE. THE $50.8 BILLION IS NOT A GOAL; IT IS A STARTING POINT.

WE WOULD LIKE TO SEE A ONE-YEAR FREEZE ON COST OF LIVING ADJUSTMENTS FOR ALL NON-MEANS TESTED ENTITLEMENT PROGRAMS, FOLLOWED BY ONLY PARTIAL INDEXATION THEREAFTER. WE FAVOR A COMPLETE FREEZE ON CIVILIAN AND MILITARY PAY, AND MAJOR REFORMS OF THE GOVERNMENT'S RETIREMENT PROGRAMS. THEY ARE WELFARE FOR THE UPPER MIDDLE CLASS. WE BELIEVE THAT THE FARM SUBSIDY PROGRAMS SHOULD BE REFORMED. IN SOME WAYS, THEY HAVE HURT AMERICAN AGRICULTURE MORE THAN THEY HAVE HELPED. WE WOULD LIKE TO FREEZE DEFENSE BUDGET AUTHORITY.

IN FACT, I CHALLENGE YOU TO COME UP WITH A BUDGET CUT THAT WE COULD DISAGREE WITH. I DON'T THINK YOU CAN FIND ONE. WE SUPPORT ALL OF THE DOMESTIC PROGRAM TERMINATIONS IN THE PRESIDENT'S BUDGET. RUNAWAY GOVERNMENT SPENDING HAS HURT MANY MORE PEOPLE THAN THESE PROGRAMS HAVE HELPED.

Don't be taken in by the spending wimps. Make the big, bold moves to cut spending and be done with it. The private sector will do its best to take up the slack, to weave a new safety net if this one gets tattered. This is your chance to be heroes and pull us back from the brink of a downward economic spiral. When in doubt, cut, cut, and cut again. I know it will be hard, but it takes diamonds to cut diamonds.

Thank you.

Chairman **Domenici**. I just want to say we have had a lot of groups testify. I really appreciate your unequivocalness about any program that is on the President's list and any others. You are not here arguing to preserve them. I think that is the most unequivocal we have had. Everybody else has some favorites.

I am not critical of those people. They all have to have some favorites.

Senator **Hollings**. I appreciate it, too, Mr. Chairman, and I notice where Mr. Smith of the chamber of commerce includes Social Security and defense in the freeze recommended by this group.

Chairman **Domenici**. Yes, indeed.

Senator **Hollings**. And I see Mr. Sloan nodding. Will the record show that Mr. Sloan is nodding.

You three are in agreement?

Mr. **Sloan**. Absolutely.

Senator **Hollings**. Good.

Chairman **Domenici**. Mr. Smith, go ahead.

STATEMENT OF VAN P. SMITH, CHAIRMAN AND PRESIDENT OF ONTARIO CORP., REPRESENTING THE U.S. CHAMBER OF COMMERCE

Mr. **Smith**. Thank you, Mr. Chairman.

My name is Van Smith. I am chairman of the board of the Chamber of Commerce of the United States and chairman of Ontario Corp., which has its principal office in Muncie, IN.

We welcome the opportunity to present our views on next year's Federal budget and to share with you our spending restraint recommendations for reducing the projected deficits that might top $200 billion.

DEFICITS CAUSED BY RAPID GROWTH IN GOVERNMENT SPENDING

In our view, the chief causes of these deficits are the rapid growth in Government spending and the recent period of below average growth in our economy. Effective solutions to these deficits are those that impose firm limits on the growth of Government spending and that encourage current economic growth expansion. Anything less than these, and we include in this tax increases, will be ineffective and will make the deficits even worse than the current projections suggest. While we share your concern about projected deficits, we view these as a symptom of a larger and more severe problem—Government spending which continues to grow at a rate faster than the growth in our economy.

The true measure of "crowding out" is the share of our GNP that is devoted to funding the many spending programs to which Government has committed us. In this fiscal year, the Federal spending share will rise to 24.8 percent of our GNP, the second highest peacetime share on record. That this near record will be set at a time of rapid economic growth suggests that Government spending is the chief cause of the deficit and that better control of Federal outlay is the solution.

As Government spending continues to claim ever larger shares of our national income, the policy debate has too often focused on the symptom and not on the problem, that symptom being the gap between receipts and outlays. Expressed in this way, the debate has often degenerated into battles to determine the proper mix of borrowing and taxation to fund the spending that Government imposes on the American people, and as that debate goes on, the political paralysis sets in, spending rises unchecked, and large deficits persist.

As we read of the Senate's deliberations this year and of your effort to create a budget that will impose dramatic restraints on spending growth, one has the impression that this unhappy description of past budget deliberations may be changing. If this view is correct, then we will have a unique opportunity now in 1985 to make this the year that the American people and their Government became serious about the threat of deficit spending.

In anticipation of an opportunity, the U. S. Chamber joined with six other major business coalitions last April to form the deficit reduction coalition to commit our vast membership to the goal of achieving dramatic reductions in Government spending rates, deficits over the remaining part of this decade. Some of our thoughts on how this could be achieved are included in the written statement which I would suggest, with your approval, we would like to submit for the record, Mr. Chairman.

Chairman DOMENICI. Without objection, it will be made a part of the record.[1]

ACROSS-THE-BOARD FREEZE RECOMMENDED

Mr. SMITH. On December 14, 1984, this coalition wrote President Reagan recommending an across-the-board freeze in all Government spending, and last week, we sent the same message to Members of Congress. We applaud the President for proposing a bold budget plan for the next fiscal year. His plan is consistent with the basic proposals of the chamber and of the business coalition for an across-the-board solution to the deficit problem.

However, we also believe that the President's budget does not go far enough. In our view, the defense budget authority for fiscal 1986 should be frozen at 1985 levels and the 1-year COLA freeze should be extended to Social Security.

Although programs important to our membership will bear some of the burden through substantial cuts, we are prepared to accept major changes in these programs if they are a part of a comprehensive and far-reaching effort to reduce the total deficit.

While firm spending restraints and major programmatic cuts will be a major component of the effort, they must work in tandem with a growth economy, an economy that expands the GNP and raises the Government's revenues.

To illustrate the power of economic growth in helping to resolve this fiscal imbalance, the OMB, at the chamber's request last year, estimated Federal spending in revenue for an economic growth path that was just 1 percentage point higher and included slightly more favorable interest rates and employment trends than the outlook included in their baseline. The results were astounding. By

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[1] See p. 541.

1988, the current service deficit would be $70 billion lower than that otherwise projected.

ECONOMIC GROWTH IS IMPORTANT PART OF SOLUTION

Economic growth is a part of the solution and an important part. But it is not the only solution. An effective and permanent solution to the deficit will require both substantial spending cuts and strong economic growth.

In this regard, it is important to recognize that strong economic growth does not occur by accident or by wishing or by chance. Sustained, rapid economic growth is the logical outcome of a comprehensive and coherent set of policies designed to unleash the creativity and enterprise of our American people. The program for economic recovery was the first step in this process. It has succeeded beyond even the most optimistic projections. But with the recovery now entering the expansion stage, Congress must turn its attention to preserving the gains and ensuring that the current robust economic growth continues for the remainder of the decade.

In conclusion, let me note that there exists throughout the country a frustration, a frustration with a seemingly uncontrolled growth in Government spending. Americans, in our own families, in small businesses, in large corporations, in local and State government, in our not-for-profit organizations, in churches have reacted with a discipline to the economic pressures of these last few years of the decade.

We can be proud of the courage and determination exhibited throughout our Nation by Americans from all walks of life as they have done tough things, tough things necessary to adjust to the challenges of economic change in our environment.

The frustration that we all have as Americans is in the failure of Congress to be just as courageous, as effective, as disciplined as are the other elements of society. While the American people took the tough steps that were needed to live within their means, Federal spending was allowed to run far beyond revenue and grew substantially in relationship to our GNP. That frustration is widespread. It is real, and it is ever present.

In his State of the Union Message, the President reaffirmed his commitment to economic growth and challenged the Congress to meet that commitment. The opportunity is yours.

Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much.

[The prepared statement of Mr. Smith follows:]

STATEMENT
on
FISCAL YEAR 1986 BUDGET
before the
SENATE BUDGET COMMITTEE
for the
CHAMBER OF COMMERCE OF THE UNITED STATES
by
VAN P. SMITH, CHAIRMAN OF THE BOARD
February 22, 1985

I am Van P. Smith, Chairman of the Board of the Chamber of Commerce of the United States and President of Ontario Corporation of Muncie, Indiana. On behalf of the Chamber's membership, I welcome this opportunity to present our views on the Fiscal Year 1986 (FY '86) budget and on the trends in federal spending that have contributed to large deficits and to share with you our recommendations for reducing these projected deficits by imposing firmer limits upon the growth of government spending.

Summary

The chief causes of these federal budget deficits are the rapid growth in government spending and the recent period of below average growth in our economy. Effective solutions to this problem of deficits are those that impose firm limits on the growth of government and that encourage the current economic expansion. Anything less than these -- and I include tax increases in this category -- will be ineffective and will make the deficits even worse than the current projections suggest they will be. While we share your concern about projected deficits, we view these as a symptom of a larger and more severe problem -- government spending which continues to grow at a rate faster than that at which our economy grows.

The true measure of "crowding out" is the share of our gross national product (GNP) that is devoted to funding the many spending programs to which government has committed us. In this fiscal year, the federal spending share will rise to 24.8 percent of our GNP, the second highest peacetime share on record and just 0.3 percent less than the all-time record reached in 1983. That this near record will be set at a time of rapid economic growth suggests to me that government spending is the chief cause of the deficit and that better control of federal outlays is the only solution.

As government spending continues to claim ever larger shares of our national income, the policy debate has too often focused on the symptom of this problem -- the gap between receipts and outlays. Expressed in this way, the debate has often degenerated into intractable battles to determine the proper mix of borrowing and taxation to fund the spending that government imposes upon the American people. And as the debate goes on and political paralysis sets in, spending rises unchecked; and deficit projections remain in excess of $200 billion per year.

As I read of the Senate's deliberations and your efforts to create a budget that will impose dramatic restraints on spending growth, I have the impression that this unhappy description of the federal budgeting process may now be a thing of the past and that we shall all have a unique opportunity to join together to make 1985 the year that the American people and their government became serious about the threat of deficit spending.

In anticipation that such an opportunity would arise this year, the U.S. Chamber joined with six other major business associations last April to form the Deficit Reduction Coalition to commit our vast membership to the goal of achieving dramatic reductions in government spending growth rates and deficits over the remainder of the decade.

On December 14, 1984, the Coalition wrote President Reagan recommending an across-the-board freeze on all government spending. We applaud the President for proposing a bold budget plan for the next fiscal year and concur with his original objective of reducing the deficit to 4 percent in FY '86, 3 percent in FY '87 and 2 percent in FY '88. Further, we believe that this objective should be met through firm restraint on the growth of spending. His plan is consistent with the basic proposals of the Chamber and the Coalition for an across-the-board solution to the deficit problem.

However, we also believe that the President's budget does not go far enough. In our view, defense budget authority for FY '86 should be frozen at FY '85 levels and the one-year COLA freeze should be extended to Social Security.

Although programs important to our membership will bear some of the burden through substantial cuts, we are prepared to accept major changes in these programs if they are part of a comprehensive and far-reaching effort to reduce the deficit.

The Federal Budget and Economic Outlook

A month ago, the U.S. Treasury reported on the first three months of the current fiscal year. It painted a grim picture of diminished progress and a worsening deficit situation. Although tax revenues have increased, reflecting the strong economy, spending has increased even faster, leaving the first quarter deficit $9 billion larger than that of last year's first quarter. Federal spending, now rising at a rate in excess of 12 percent, is growing twice as fast as it was last year, three times faster than the rate of inflation and a third faster than the growth in our gross national product. As a consequence, we are rapidly losing much of the progress we made last year when we shaved $20 billion from the deficit and reduced the budget's share of our GNP. Should the current rate of spending persist, it is not unreasonable to project deficits of a quarter of a trillion dollars by the end of the decade.

It is an awesome gap and one that will require heroic efforts to close. Firm spending restraint and major programmatic cuts will be a major component of the effort but they must work in tandem with a growing economy that expands the GNP and raises the government's revenues.

Last year, we met with officials of the Office of Management and Budget (OMB) to discuss this issue and had them estimate the budgetary impact of alternative economic growth paths. To illustrate the power of economic growth in helping to resolve the fiscal imbalance, the OMB estimated federal spending and revenues for an economic growth path that was just one percentage point higher and included slightly more favorable interest rates and employment trends than the outlook incorporated in their baseline. The results were astounding. By 1988, the current services deficit would be $70 billion lower than what was otherwise projected. I don't need to tell you how difficult it would be to achieve additional spending cuts of that magnitude or how debilitating a tax increase of that size would be to the health of our economy.

However, as the debate on this issue has evolved, the role of economic growth and its impact on the deficit have been misunderstood. Because of this confusion, let me try to clarify the issue as we see it. Economic growth is part of the solution, and an important one at that. But it is not the only solution. An effective and permanant solution to the deficit will require both substantial spending cuts and strong economic growth. Each by itself is insufficient. Together, they can bring us close to a balanced budget by the end of the decade.

We must recognize that strong economic growth does not occur by accident or by chance, or by wishing that it happens. Sustained, rapid economic growth is the logical outcome of a comprehensive and coherent set of policies designed to unleash the creativity and enterprise of the American people. The Program for Economic Recovery was the first step in this process, and it has succeeded beyond even the most optimistic projections. But with the recovery now entering the expansion stage, we must turn our attention to preserving the gains and ensuring that the current robust economic growth continues for the remainder of the decade.

To achieve this, Congress must consider a broad set of policies and enact programs to enhance the economic health of our nation. Chief among those policies is a firm resolve to restrain federal spending and diminish the share of our national income and wealth that it now absorbs at near record levels. By restraining spending, we free scarce resources that can be used for productivity-enhancing investment in the private sector. Other key reforms that must be enacted include comprehensive tax reform to encourage investment and improve the incentives for savings and entrepreneurship; a stable monetary policy to reduce financial uncertainty and allow the economy to grow at its full potential; a strong commitment to an open trading system, through restraint on protectionism at home and expanded multilateral trade agreements abroad; additional deregulation of the economy; and an agressive effort to privatize many services now performed by the government. This latter reform will lead to both enhanced economic productivity and significant budget reductions.

With a firm commitment to pursue these objectives, we believe that the current economic expansion can be sustained for the rest of the decade at rates close to 5 percent per annum. Some argue that such growth is not feasible and that capacity constraints limit our potential. This argument is simply not valid. Capacity is a dynamic concept that can expand with new investment and new technologies. In the last several years, we have added significantly to our capacity as a result of the new accelerated cost recovery system that has increased the return to capital investment and encouraged businesses to fund the strongest capital spending boom of the postwar era. The reduction in the capital gains tax rate has created a vast pool of risk capital to finance a record number of new business formations with no net revenue loss to the Treasury. Moreover, with unemployment still above seven percent, we are nowhere near the point of achieving the full employment of our work force. Much slack remains in our system, and a commitment to growth will both expand job opportunities and narrow the deficit.

What Can Be Done to Reduce Spending Growth and Cut the Deficit

Although a rapidly expanding economy can narrow the deficit at a faster pace than most forecasters now project, severe "crowding out" will persist as the federal government aborbs more than 24 percent of our nation's production of goods and services. The only way to resolve this problem is to limit federal spending growth by imposing firm restraints on those programs that are responsible for the rapid growth we have experienced over the past many years.

Recognizing that the budget deficit situation would likely worsen and that 1985 would offer Congress the unique opportunity to make dramatic gains in spending restraint, the Chamber and six other major business associations joined together last April to form the Deficit Reduction Coalition. The purpose of the Coalition was to use our many skills to develop a program for federal fiscal integrity and to unite our organizations in an all-out effort to limit government spending. Meeting biweekly during most of 1984, we were able to forge a united group and develop a proposal for spending control.

On December 14, 1984, the Coalition wrote to the President recommending the implementation of a one-year freeze on all federal spending. While a freeze proposal may be considered dramatic by some, we believe it is a solution commensurate with the problem. Such a freeze should be comprehensive and equitable. No program should be "held harmless" or considered sacred. In our view, any freeze proposal must include the following provisions:

--All cost of living adjustments (COLAs), including those for social security, should be frozen for FY '86, followed by increases of less than 100 percent of the consumer price index in subsequent years.

--Aggregate spending for nondefense discretionary programs should be frozen at FY '85 levels for at least FY '86.

--All civilian and military pay should be frozen at FY '85 levels for FY '86. Further savings in federal pension programs can be obtained by making them more comparable to prevailing private sector pensions.

--Defense budget authority for FY '86 should be frozen at the FY '85 level followed by 4 percent real growth in subsequent years. To the extent possible, such spending levels should be achieved by program stretch-outs and management efficiencies.

--Farm subsidy programs must be fundamentally reformed to reflect savings comparable to those recommended for other programs.

--Means-tested programs should be allowed to adjust for inflation and accommodate new beneficiaries. However, to the extent possible, the Grace Commission recommendations to improve targeting, efficiency and management should be adopted.

In early February, the President released his budget proposal for FY '86. It is a bold plan and would accomplish much by limiting spending growth. We applaud him for his bold plan and believe that his objectives are consistent with the Chamber's proposal for an across-the-board solution to deficit spending. While we strongly endorse the President's efforts to cut spending, we believe that it is essential to go further in the areas of defense and Social Security which together constitute more than half of all federal spending.

The inclusion of these additional measures of spending restraint will create a greater sense of equity and shared sacrifice and will enhance the prospect of enacting substantial spending cuts in the next budget. Moreover, these measures will also achieve even greater budget savings than the President has proposed.

Tax Increases: Ineffective and Counterproductive

Despite all the evidence that runaway spending is the problem, many in and out of government continue to adhere to the belief that a substantial tax increase is the cornerstone of an effective deficit reduction package. A few years ago, many of these same individuals predicted that without a substantial tax increase we could not achieve a vigorous economic expansion. Consequently, their forecasts for 1983 and 1984 were generally pessimistic.

In contrast, the Chamber insisted that tax increases would jeopardize the recovery, reduce the tax base, and increase the deficit. We continued to believe in the President's Program for Economic Recovery and the tax relief that it promised. The record speaks for itself. We are now in the midst of a solid economic expansion that has outperformed even the most optimistic of the forecasters. Economic growth and capital investment in 1984 were the highest since the early 1950s. Inflation has moderated, and interest rates continue to fall despite "expert" predictions to the contrary. With the same set of incentives still in place and no major tax increase on the horizon, the Chamber's Forecast Center projects another year of above average economic growth in 1985.

To us the message is clear. The basic prerequisite for a strong and growing economy is limited taxation and a tax system that encourages savings, investment and entrepreneurship. Indeed, as we survey the varying measures of performance in countries around the world, we invariably find that those countries with high rates of growth have low marginal tax rates while those with a persistent pattern of stagnation have high tax rates and burdensome government. Countries that continue to grow and enrich their population have economic systems that reward work, enterprise and creativity. But these incentives cannot be maintained with a government budget policy that feeds runaway spending by burdening workers and businesses through rising taxation.

We must realize that massive tax increases will not reduce the deficit and may even worsen it by diminshing economic growth. All too often, the logic behind a tax increase is based on a faulty accounting perspective of tax revenue. The argument is that tax revenues expand by the increase in the tax rate multiplied by the existing tax base. However, this static estimate of tax revenues fails to take into consideration the disincentive effects of higher tax rates upon the tax base. Specifically, rising tax rates mean less economic growth, less income and profits, and less tax revenue. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) illustrates this point. In conjuction with modest decreases in some spending, TEFRA, when enacted, promised a $103.9 billion deficit in FY 1983 and an $83.9 billion deficit in FY 1984. These targets, of course, were never achieved. Revenues failed to rise, and spending exceeded targets by a substantial margin.

While TEFRA failed to live up to its promise, the accompanying neglect of the spending side of the budget is partly responsible for the deficit that confronts us today. Federal spending continued to expand, continued to "crowd out" the private economy, and remains, as a consequence, a more difficult problem to resolve than it was three years ago.

With this prologue, I am delighted to find that the President and many members of this committee and the Congress intend to devote their efforts to a deficit reduction strategy that relies entirely on spending restraint. We applaud this objective and, for our part, will devote much of our resources and advocacy efforts over the next many months to assisting you in accomplishing this goal.

Conclusion

Less than four months ago, the American voters overwhelmingly elected a President and Congress which promised to hold the line on taxes, curb spending growth and keep the economy on a rising trajectory. In doing so, they affirmed their support of the pro-growth programs enacted at the beginning of the decade and voted for more of the same.

There exists throughout the country a frustration with the seemingly uncontrolled growth of government spending. Americans, in their own families, in their small businesses, in large companies, in their local and state governments, in their not-for-profit organizations and churches have reacted with discipline to the economic pressures of the last several years.

We can be proud of the courage and determination exhibited throughout our nation by Americans from all walks of life as they have done the tough things necessary to adjust to the challenges of a changing economic environment.

The frustration we all have as Americans is the failure of Congress to be as courageous, as effective and as disciplined as are the other elements of our society. While the American people took the tough steps that were needed to live within their means, federal spending was allowed to run far beyond revenues and grew substantially in relation to our GNP. This frustration is real, widespread and ever present.

In his State of Union address, the President reaffirmed his commitment to economic growth and challenged Congress to meet that commitment. The opportunity is yours. By focusing your efforts on a program of significant spending reduction and defeating any effort to increase taxes, you can provide the basis for sustained economic growth.

Chairman DOMENICI. Senator Hollings.

Senator HOLLINGS. Yes, Mr. Smith; right on that point.

"The frustration we have as Americans is the failure of Congress to be as courageous * * *." Now, earlier in your statement, you said the results were astounding, that 1 percent growth and how the deficit would be $70 billion lower.

Mr. SMITH. Yes, sir.

Senator HOLLINGS. Whoever wrote that for you—fire him. We had that economist write that for us Democrats all during the 1970's. All we needed was 1 percent growth more and that is how we started running up the deficits.

So I do not know how that fellow got loose and turned up in your office, but get rid of him. I can tell you that right now. That is the reason we are into trouble. [Laughter.]

COURAGE LACKING BY CHAMBER OF COMMERCE

But I want to address this point. Last April you formed a deficit reduction coalition, and then you jumped to December. Now, in May, we were trying to vote up here on just what you are talking about, a budget freeze, and right to the point about being courageous.

You go to these business groups and they all talk about courage in the Congress, courage in the Congress. We are elected by politics. The public we respond to very, very quickly. We respond to the chamber of commerce, the Federation of Independent Business, all your different groups.

But when we cannot find your groups wanting anything, do not talk about courage. The lack of courage was in the chamber of commerce. I say that advisedly. I tried to get them in this town to help us pick up a vote. You could not get one of them.

I got your predecessor, Bob Thompson. He was still nagging about Bacon-Davis. He is about 3 years out of style. I said, "If we do not move now, when are we going to move?" If not now, if not who, when, and all that thing?

We could not get anybody in the chamber of commerce, and you are dead right. You organized in April and then got together after the election. Now, I know what happened. You had a higher priority. You wanted to reelect the President, and you could not come with a crisis in April before his election. So you cooled it. You ran your double page ads with our friend Pete Peterson.

I am just finding out in the New York Times what was happening to him. They were shoving him out of the window up there when they were writing those ads. I wondered about those ads talking in April and May about after the election.

If I came down the steps of the Capitol in Columbia, so you will understand it, and someone shoved a microphone under my nose and said, "Governor, what are you going to do about the $200 million deficit?" which would be comparable to the $200 billion, and in April, I read back and said, "Well, you know, this is an election year, and there are a lot of fallouts and things that happen in an election year, but after the election, we are going to get to work on it," they would run me out of office down in South Carolina. You could not get by with that political nonsense.

You folks set the pace, and I am right back to you now. Do not talk about courage in the Congress. We need a presence in the Congress of these groups who are interested as you are. That is why I am so interested in your appearance, all three of you here this afternoon to act and move now, and as the distinguished chairman has pointed out very well. Do not pallaber about just exactly how to do it because we have heard enough. It is got to be spending. Another group, it has got to be defense. No; it must be revenues.

It has got to be all of the above. When you are looking for $200 billion over about a 4- to 5-year period, you are going to have to touch on every bit of it but we need your help, not just a pill now and then write out a letter to the members.

I want you all to use the chain of telephone calling. You know how to do it, use those computers and get on all of us here in the next 60 days. Do not just go back and say we appeared and they had a picture of you in the chamber news and told them we needed more courage in the Congress.

The farmers have gotten their message through. We are holding up the whole Government because we know and we understand, and similarly with respect to this deficit, if you three can really coordinate and bring the pressure on, we will get something done, but if you do not in the next 60 days, we are gone.

It is not courage. It is politics. We need to hear from you.

GROWTH, COURAGE, AND THE ELECTION PROCESS

Mr. SMITH. Three words struck me as you made some comment, Senator. Growth, courage, after the election. In the area of growth, I think it is astounding to see what 1 percentage growth in our gross national product can do for this country in presenting opportunities to our citizens, in moderating what otherwise, without that growth, would be substantial economic pressures. It is in that sense that I think we want to keep the focus, as far as the Chamber is concerned, on the importance of seeing our economy continue to grow.

If one were to look at the great experience we had this last year, we exceeded the anticipated economic predictions of many people by experiencing the greatest growth we have had in three decades, and we would like to see that growth continue. That is the thrust of those comments.

Insofar as political courage is concerned, I have had the opportunity of running for office. I have been elected and defeated in our State. I served in the State legislature, on the Ways and Means Committee. I think there are a couple of things that exist when we talk about elected officials, and I would yield to the great experience you have had in the great State of South Carolina.

There is, within the character of the political animal, the capacity to follow the crowd or to be a leader. It takes courage to be a leader, and I would share with you both in the sense of the contemporaries with whom I served in the legislative bodies, and when I look at members of the U.S. Congress, in either political party, oftentimes with whom I philosophically agree or do not agree, I have great admiration for those who tend in their position to exert leadership and courage. It is in the sense that we would suggest and want to encourage those who have the leadership to realize it is tough to make these political decisions, to have the courage to get out and do it, and we think you have the support of the majority of the people in the country when that is done.

The election process, I think the business community reorganizes the importance of the job that you face this year. We recognized that we could make a contribution in the business community, many trade associations, if we could give to those who were willing to take a leadership role some support of the business community in as unified a manner as possible.

There have been times in the past, you will recall, when the business community of the country has not been able to bring much unity to their position. Therefore, there was, in recognition of what would face this Congress, a move at the end of the spring last year to begin to put a coalition together.

The coalition, while the dates of May and then November might have been mentioned, actually met every 6 weeks. The coalition met continuously during that period, hammering out some positions that we could uniformly support, and it was not to be a part of any partisan political election.

It was decided that they should be made public and that if they would be helpful in presenting a uniform platform, we hoped that the legislature would put their feet on them and find them supportive, sir. Thank you.

Senator HOLLINGS. Just one, Mr. Chairman.

Chairman DOMENICI. Sure.

REDUCTION IN FEDERAL DEFICIT IS CRITICAL

Senator HOLLINGS. I thank you and our colleagues for your indulgence, and we want to hear from Mr. Sloan. I would hold up on Mr. Albertine's rosy analysis of 1984 and the wonderful balanced recovery, finest we've ever had. You know, we listen to a lot of minds and brains, and we are worried.

We were told we were going to have the finest economic recovery after we passed the President's program in August of 1981. Then we looked in 1982 and it has a negative investment by business in plant and equipment.

Then we looked in 1983 and he said stay the course. It is going to be wonderful and rosy, and in 1983, it was again a negative investment in plant and equipment in 1983. Since we cut the revenues, income tax some 25 percent, you have gone into what they tell us is a demand kind of recovery, and it is not all that balanced, and since January, the indications are after the first 6 weeks, that there is not as much in business and equipment, and it is getting to be very tenuous.

So I am not going to argue it. You are the economists and know better than I do, but I wish it were the best, most balanced recovery we ever had. That is why we are worried about these deficits because it has been mostly demand and pent up, but it is not going to be complete and continuous in any shape, Dr. Albertine, unless we do something about these deficits.

Dr. ALBERTINE. Senator, it may be a useful exercise from an academic point of view for me to argue with you about what happened in 1982, 1983, and 1984, and I think we probably have some area of disagreement.

But the critical issue is what is going to happen in 1985 and 1986.

Senator HOLLINGS. Right.

Dr. ALBERTINE. I do not disagree at all. I think it is very critical that we get some reduction in the Federal deficit. We must convince the Federal Reserve that action is going to be taken. I do not think there is any question about that.

Senator HOLLINGS. Thank you, Mr. Chairman.

Chairman DOMENICI. Thank you very much, Fritz.

Mr. Sloan?

STATEMENT OF JOHN SLOAN, PRESIDENT AND CHIEF EXECUTIVE OFFICER, NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Mr. SLOAN. Mr. Chairman, I am John Sloan, the president of the National Federation of Independent Business, and on behalf of NFIB and our over 500,000 members, I appreciate this opportunity to share our concerns about the deficit and the proposed budget solutions.

If I might, Mr. Chairman, ask that our formal, rather lengthy statement be made a part of the record and let me just take a few minutes to summarize our thoughts.

Chairman DOMENICI. It will be made a part of the record.[1]

NFIB URGES CUTS IN SPENDING

Mr. SLOAN. The NFIB is no stranger to working on the cause of reducing deficits. Over the last 4 years, we have worked hard on behalf of our members to encourage reduced government spending and have, on a number of occasions, supported cuts in programs that come close to our hearts.

My predecessor was here 4 years ago urging at that time a 25 plus percent reduction in the Small Business Administration. I was yesterday before Senator Weicker's committee urging major reductions in spending in that area to be consistent to the proposition that we all have to share if we are going to reach the goals that we are after.

NFIB strongly supports the proposition that we must cut spending at least by $50 billion this particular year. We do, however, have some concerns about whether the proposal as we see it in the President's budget will actually accomplish that, and in that regard, we begin with the premise that we worked very hard on last year and as did many of you.

I appreciate the comments of Senator Hollings in this regard because last year there were times we felt like we were kind of the sole voice of business urging that Congress begin with a budget freeze.

Senator Sasser is another one whom I appreciate very much who worked very diligently in that area, and, again, being fellow Tennesseans, I particularly have appreciated his interest in that area.

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[1] See p. 559.

We are again here this year suggesting that at least a starting point must be that consideration, that there are parts of that budget that cannot be left out. We think the people of the country are ready to support you.

We at NFIB are anxiously eager to support an effort to put a freeze in those areas such as the Social Security COLA area. I think unless those areas are dealt with, it will be very difficult to reach that $50 billion goal.

We do not believe, however, that we can sell freezing the Social Security COLA area if it is left to stand alone that way, and that areas of defense are going to have to participate here, too.

This includes the same area when we talk about a lot of those fancy pensions over there. We at NFIB, our small business people do not have those kind of fancy pensions, and we believe the whole spectrum there is going to have to be looked at if we are going to reach this mutually agreed upon goal of a $50 billion cut.

So we at NFIB urge you to go forward to a broader swipe here and that we begin with at least a freeze.

ADDITIONAL CUTS WILL BE NEEDED

Now, frankly, our figures indicate that if we just simply did that, we would not reach the full $50 billion. We would probably be still as much as $15 billion short, and that in that regard, there are going to have to be some additional program cuts.

That is why yesterday, as I mentioned, we were before the Small Business Committee proposing an NFIB plan for reducing expenditures in that one area alone by 60 percent.

We are ready to stand behind sharing in the cutting and would urge that the other interest groups around the country take the same sort of attitude in supporting you gentlemen in reaching that level of cuts.

Let me conclude by saying this. The time has got to be now. If we are under the threat of a $200 billion deficit during such times of prosperity, heaven help us if we go into a recession without having done something.

We might then be talking about the backbreaking figures of $400 billion. So the time must be 1985, and we at NFIB, as with my colleagues here, look forward to being as supportive as we possibly can be.

Yes, Senator Hollings, we will have the letters and the phone calls coming to help you get that accomplished. Thank you very much.

Senator HOLLINGS. Thank you.

Chairman DOMENICI. Thank you.

NFIB® National Federation
of Independent Business

The Guardian of Small Business

STATEMENT OF

JOHN SLOAN, JR.
PRESIDENT AND CEO

NATIONAL FEDERATION OF INDEPENDENT BUSINESS

Before:	Committee on the Budget, U.S. Senate
Subject:	Budget for Fiscal Year 1986
Date:	February 22, 1985

Mr. Chairman, my name is John Sloan, and I am President and Chief Executive Officer of the National Federation of Independent Business (NFIB). On behalf of the more than 500,000 small firms represented by NFIB, I would like to thank you for this opportunity to outline the small business perspective on the budget and the economy, and to detail our proposals for reducing the federal budget shortfall.

Congress has reached a decisive moment in the struggle to reduce the deficit. Unless immediate steps are taken, deficits will exceed $200 billion in each year remaining in this decade, and they will continue to increase as a

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percentage of Gross National Product (GNP). Today I hope to convince you that Congress can no longer afford to vacillate or seek partial solutions. The choice it now faces is clear: either take swift and comprehensive action to reduce the deficit, or risk the economic crisis which this problem, left unchecked, may precipitate. Should Congress choose to take action, as we all hope, the legislative solutions at its disposal will be limited by budgetary and economic realities. The remarks which follow will try to explain how NFIB views these realities and what consequences we see for budget policy-making by this Committee.

The Deficit Problem

While the consensus for reducing the deficit is broad, it is not infrequent tnat the reasons for pursuing this objective get lost in the debate. NFIB is no newcomer to the fight for lower deficits. For a long time we have advocated a return to fiscal responsibility, supporting the specific goals of individual balanced budgets and the general goal of a balanced budget amendment to the Constitution; our support for these objectives is a matter of practical consequences as well as of principle. NFIB is convinced that large and growing federal deficits pose a serious threat to both short term economic health and long term national prosperity. Small businesses want deficits reduced because they are harmful to economic growth.

To be sure, no one really knows precisely what the effects of the deficit are. However, it is completely consistent with what we know about economics to suspect at least three grave consequences: First, federal borrowing to fund deficit spending involves frequent raids on the limited supply of lending capital available in the market. When the government borrows money, it does so at the expense of private borrowers who must compete for the same limited pool of capital. According to the President's 1986 Budget, since 1980 the share of total private wealth accounted for by the federal debt has risen from 6.2% to 9.4%. The upshot of this practice is that private borrowers, among whom we count America's job producing companies both small and large, must pay interest on their funds that is artificially inflated by deficit-financing. This effect, though real, is difficult to measure. In recent times interest rates have declined somewhat, even as deficit-driven federal borrowing has increased. The explanation for this lies in the willingness of foreigners to purchase our debt and thus mitigate the upward pressure on interest rates caused by federal borrowing.

This brings us to the second debilitating effect of the deficit. Stimulated by high real interest rates and confidence in our economy, foreign investment strengthens the external value of the dollar and creates the false appearance that the deficit is having limited ill effects on interest rates. Our current trade situation, particularly for America's manufacturing sector, is virtually a crisis. This situation has been brought on by a U.S. dollar now worth nearly twice its value of a decade ago compared to European currencies. But the power of the dollar, and the protection foreign investment provides to domestic interest rates, rests on the continued good will and confidence of foreign investors. Thus the deficit places us in a very precarious position concerning interest rates and trade. Any substantial decline in the external value of the dollar will force our economy to finance a higher percentage of the deficit, with drastic effects on interest rates and investment. At the same time, such an adjustment would begin to reverse trade flows, ending the influx of low-cost imports that has helped keep inflation comparatively low. In sum, continuing the policy of deficit spending means gambling that the dollar will maintain its unusual strength--an injudicious bet, given the stakes involved.

Finally, one of the most important effects of continued high deficits (one often overlooked) is the erosion of public confidence in government that occurs. There can be no mistaking the message intended by the people in the last election. America wants the deficit whipped now, and it will be watching carefully how Congress responds to this mandate. To be sure, the job of reducing the deficit will involve disappointing those sections of the electorate that continue to expect budgetary handouts. But the vast majority of the people look to Congress to apply equitable changes that will close the budget gap. Failure to meet this challenge cannot but have a discouraging effect on the populace and the marketplace as well. Only if the deficit is significantly reduced will the people remain confident that sustained economic growth is possible; this confidence, or lack of it, promises to have a self-realizing effect on the economy.

The Economy and the Deficit

The foregoing are some of the consequences that arise from a growing deficit. It is critical, however, that these be placed within the context of current economic conditions. Only then does the degree of urgency for action on the deficit become apparent and realistic approaches to addressing the problem become evident.

For over ten years the National Federation of Independent Business has published its Quarterly Economic Report. This survey of small firms has produced unusually reliable data on short term economic trends including investment, inventory growth, hiring, capital expenditures, inflation, and borrowing, as well as a general index of small business optimism concerning the economy. Our most recent QER was released last Wednesday, and it contains a perspective on the economy useful to budget considerations. (A copy of this report is herewith submitted for the record). Overall, the economic news was quite bright. Small firms are generally optimistic about prospects for growth in the coming year. Based on its survey, NFIB predicts that real GNP will grow by five to five-and-a-half percent in the first quarter. The only sign of trouble that can be detected from the current survey is an indication that a significant number of small firms (28%) plan to increase prices in the upcoming quarter. This is the highest percentage in this category in two-and-a-half years, and may signal new inflationary pressures; certainly this area will bear watching.

The budgetary implications of NFIB's economic report are mixed. On the one hand, the economy seems to be on track toward sustained growth. If GNP grows at a rate in the range of five percent, then federal receipts should remain high and tend to offset deficit growth. On the other hand, growth in inflation could cause the Federal Reserve to tighten monetary policy, increasing borrowing costs to the government and forcing net interest payments up. Perhaps the best overall assessment of the report's meaning is that there appears to be no immediate concern for an economic downturn, though this should not serve to console those concerned about the long term effects of the deficit. On the contrary, good news about the economy should be viewed as continued good fortune in the face of increasing economic vulnerability. It is precisely because the economy is in very good condition that there is cause for alarm. Even under optimum economic conditions, growth in the deficit is outpacing growth in GNP; any economic decline would cause the gap between receipts and outlays to widen dramatically. It is exactly because the economy is on course that we can still afford to take the bold steps necessary to rein in the deficit. If Congress fails to face this job now, it will be much more difficult--perhaps impossible--to do so when the economy is performing less well. Congress now has the best conditions it can hope for to reduce the deficit; NFIB urges it to act before it is too late.

The President's Budget

On February 4th the President submitted his budget proposal for fiscal year 1986 to the Congress. His stated goal had been to reduce the deficit to $100 billion by 1988. Despite drastic cuts in a wide range of discretionary programs, the President's proposal fell $44 billion short of his goal. It would, however, reduce the deficit by $51 billion in 1986 and $239 billion over the period 1986-88. For proposing these reductions the President is to be commended. His budget is essentially an aggregate freeze of 1985 spending, exclusive of net interest payments on the public debt. NFIB believes that no program should be funded at a level greater than its 1985 budget authority, and some programs should be funded at a lower level so that a first-year savings objective of $50 billion can be reached.

In spite of broad agreement with the President's budget in terms of overall deficit reduction figures and the need for sharp curtailment of programmatic spending, NFIB differs with the President on a number of issues. In particular, NFIB opposes outright termination of the Small Business Administration. Does this mean that we are willing to see the budget cut so long as our interests aren't included? Absolutely not. I would like to submit here for the record a copy of NFIB's proposal to reform the SBA. In this the Committee will find that we favor a 57% reduction in the SBA budget, together with program changes that will make remaining SBA functions more efficient and in some cases self-sustaining. Our proposal, if employed, would save as much as $1.5 billion over a three-year period. NFIB and its small business members are anxious to do their fair share in the effort to reduce the deficit. We urge the Committee to give careful attention to our SBA proposal, and also urge that the program budget authority and outlays we have recommended be specifically included in any Budget Resolution or Reconciliation Instructions the Senate may pass.

NFIB differs with the President's proposal in other areas as well. This is especially true concerning the treatment of defense spending and Social Security COLAs. In 1984, according to the Congressional Budget Office, about 45¢ of every budget dollar was spent on entitlements (about 40% of this was Social Security), 26¢ on national defense, 17¢ on nondefense discretionary programs, and the remaining 12¢ on net interest. Entitlement spending (other than COLAs) and net interest payments are not subject to budgetary control, thus 57¢ is essentially exempt from budget cuts. To this the President has added national defense, rendering about 83% of the budget untouchable for the purposes of deficit reduction. This problem is compounded by the fact that net intetest costs are growing, leaving a progressively smaller amount to pay for all other budgetary functions. NFIB believes that defense spending and Social Security COLAs must be considered parts of any serious and equitable deficit reduction package. Current levels of inflation would make a freeze on Social Security COLAs no hardship for beneficiaries, and the evidence is convincing that the President's defense spending increase proposal could be significantly reduced without impairing national security. For this reason NFIB urges the Committee to use the President's budget as a starting point, but to bring defense and Social Security COLAs under consideration in any deficit reduction plan.

NFIB's Budget Proposals

NFIB believes that the deficit as a percentage of GNP should be reduced from its current figure of over 6% to a level at or below 3%. A good start toward this goal could be achieved by a first year budget savings of $50 billion. While the President's budget would meet this first year objective, NFIB remains concerned that the approach it would use is not equitable.

NFIB proposes that Congress employ a comprehensive freeze of the budget as the first element of an overall plan to reduce the 1986 budget by $50 billion. Given current economic conditions, a one-year comprehensive freeze (including real defense expenditures and Social Security COLAs), would save $35 billion in the first year and $168 billion over the period 1986-88. To the foregoing Congress should add individual program savings such as those we have proposed for the SBA and the President has proposed for a number of other discretionary programs. The margin of $15 billion could be made up from these savings in an equitable manner.

In considering the possibility of a comprehensive freeze and the difficult questions of defense and Social Security, the Committee should keep a number of factors in mind. For example, defense and entitlements are the largest parts of the budget. A freeze in real defense spending would still allow the defense budget to grow by about 4% in nominal terms. A Social Security COLA freeze will not reduce outlays, only reduce the increase in outlays; beneficiaries will get the same amount they got in 1985 in nominal terms. It will be important for Congress to find a budgetary balance on Social Security COLAs and defense spending--a "quid pro quo" if you will--to get bipartisan support for a comprehensive freeze. NFIB joins a number of other business groups in urging the Committee to work toward this objective. A copy of a letter we have sent to Congress in support of a comprehensive freeze is here submitted for the record.

The Committee should also note that there is a broad constituency for a budget freeze, even on defense and Social Security COLAs. A recent survey of NFIB members revealed some interesting facts: 86% of small firms polled believe that eliminating the deficit is the nation's highest priority; 75% believe the defense budget can be cut; 60% also said Social Security and other entitlement programs could be cut. (A synopsis of this survey is submitted here for the record). In separate polls, 80% of NFIB members have favored a one-year across-the-board COLA freeze to help reduce the deficit, and 70% favor an overall budget freeze.

NFIB agrees with the President that a tax increase to reduce the deficit is completely unacceptable. There are two clear reasons why a tax increase is unjustified: first, the deficit arises from too much government spending, not from inadequate taxation. Since the 1960's receipts have averaged around 18.5% of GNP; however, since the mid 70's outlays have increased steadily as a percentage of GNP, with the 1985 figure fully two percentage points higher than that of a decade before. There is no reason to believe that new revenues might not simply be spent by Congress instead of being applied to the deficit. Second, the goal of reducing the deficit is to improve the climate for sustained economic growth. A tax increase is an economic disincentive; it takes funds out of the economy that might otherwise be used for savings and investment. On these bases we urge the Committee not to include any revenue increase as an element of its final budget proposal.

Conclusion

America is now enjoying an extraordinary period of economic prosperity. On the basis of our surveys, NFIB is convinced that the potential is there for the economy to enter a rare period of sustained growth. The realization of that potential depends almost entirely upon the actions of this Committee and the Congress as a whole. Failure to address the widening deficit, or the decision to do so by increasing taxes, could well lead to economic recession. CBO estimates that, barring any serious deficit reduction effort, a recession could force the deficit over the $400 billion mark by the end of the decade. The alternative is for Congress to take the only broad and equitable deficit reduction step it can: to pass a comprehensive budget freeze--to which should be added the programmatic changes necessary to bring savings up to the $50 billion level for 1986. In this case the outlook is good for prolonged growth, with a good opportunity to heal those sectors of our economy that have been damaged by the last recession and to effect the long term economic changes America needs to remain competitive in the world market. Without meaningful deficit reduction now, America's economic recovery is living on borrowed time.

Thank you.

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Chairman **Domenici**. Let me, because I do not want to fail later on to thank all of the Senators for the last couple of weeks. It has been pretty tough, and we have had pretty good attendance. I appreciate your being here this afternoon. We are not going to go on too long, and I did not want to forget to say that.

Let me just ask two questions both of Mr. Smith and Dr. Albertine. I think I understand. Both of you have members in your organizations that do business with the Department of Defense, is that correct?

Mr. **Smith**. Yes.

Dr. **Albertine**. Yes.

Chairman **Domenici**. I would assume the National Chamber has a significant number, is that correct?

Mr. **Smith**. We do, yes, sir.

ONE-YEAR BUDGET AUTHORITY FREEZE IN DEFENSE

Chairman **Domenici**. Do I read you correctly that both of you are saying you have looked at this and that you would support a one-year budget authority freeze in defense if it is comprehensive and all-inclusive?

Dr. **Albertine**. Yes.

Mr. **Smith**. That is correct.

Chairman **Domenici**. That means if eveiything else in budget authority is frozen and all costs of living and pay is frozen, as I understand the basic.

Dr. **Albertine**. Yes.

Mr. **Smith**. Yes.

Chairman **Domenici**. Now, you both understand if you add that up, that is still not going to get you the $50 billion deficit reduction, and it surely is not going to get you anywhere close to $100 or $110 billion out there over 3 years. So I assume you have looked at the list of the President's domestic cuts that are over and above a freeze?

Mr. **Smith**. Correct.

Dr. **Albertine**. Yes.

CUTS IN EXIM BANK ARE SUPPORTED

Chairman **Domenici**. You are recommending half of the President's reductions. What is the position of the Chamber of Commerce on the Ex-Im Bank proposal?

Mr. **Smith**. Mr. Chairman, we recognize in the domestic end of the budget that there are a lot of options and that many of them would impose a lot of restraint and encumber many of the programs that our members are involved in.

But if across-the-board we can do that, we think that a freeze on the domestic side is a policy that should be followed. When one comes to the Ex-Im Bank, we are prepared to support substantial reduction in the direct loan program of the Ex-Im Bank.

Chairman **Domenici**. How about you, Dr. Albertine?

Dr. **Albertine**. Mr. Chairman, obviously it would not be our first cut. It is not our favorite one, but we would support it. As I said in my opening statement, there are no cuts in the President's budget that we would not support.

I do not believe that this committee is capable of coming up with any cuts that we would not support.

Chairman DOMENICI. I yield to the Senator from Florida.

I wanted to first ask one thing for the record. You said there are six business groups that have joined the coalition that you described as the Coalition To Reduce Federal Deficits. Could you state what the groups are, Mr. Smith, for the record, please?

Mr. SMITH. That letter was signed, Mr. Chairman, by the three groups that are present here. Let me read them to you. National Association of Manufacturers, the American Business Conference, the American Electronics Association, Chamber of Commerce of the United States, the National Association of Realtors, National Association of Wholesalers and Distributors, and the National Federation of Independent Business.

Chairman DOMENICI. I thank you.

Senator Chiles?

CONCERN SHOWN FOR FLAT CORPORATE RATE OF 33 PERCENT

Senator CHILES. Mr. Sloan, in your statement your members are saying they are concerned about doing anything on the revenue side, because that money might be used for additional spending, and also, they do not want to see any change in what would be the incentives for growth.

Does it concern your members at all that the middle and smaller corporations of this country are paying a reasonable rate towards the 40 percent corporate tax and yet some of our largest corporations are paying zero tax dollars to the Federal Government under the existing structure?

When I go speak to groups of small businessmen, they raise hell with me about that. They cannot understand why we have got this kind of situation. I do not know whether you find your members are concerned about that or not.

Mr. SLOAN. As a matter of fact, in that direct regard, no we are not getting any particular overwhelming protest. But it is interesting that in that area our members are showing great concern at the idea that there be a flat corporate rate of 33 percent at a time when basically most of our members earn less than $100,000 and their corporate tax rate is more on the order of 15 percent or 18 percent.

In fact, that is one of the reasons that we appreciate, for instance, in Senator Kasten's reform proposal continuing a graduating position on corporate tax rates, because most of our members, Senator Chiles, are earning less than $100,000 frankly, and they are not being taxed at the 46-percent rate.

Senator CHILES. Well, if they are being taxed at a 15- to 18-percent rate, that is 15 to 18 percent higher than some of our largest corporations are paying. Does that concern them?

PAYROLL TAX A GROWING BURDEN

Mr. SLOAN. On incidental occasions, yes, but there has not been any great ground swell that they are overwhelmed by it. I mean, our membership is so broad that I end up with that sector who are capital intensive, who have the same opportunities through investment tax credits and depreciation schedules to also limit their tax liability.

Unfortunately, most of our members will tend to be more labor intensive and what we hear most from them is not the concern of corporate tax rates but the growing burden of the payroll tax to them rather than the income tax.

Senator CHILES. Well, a lot of your members, then, are not incorporated to start with.

Mr. SLOAN. That is right.

Senator CHILES. They are proprietorships.

Mr. SLOAN. That is right, sir.

Senator CHILES. So they have what we call a minimum tax.

Mr. SLOAN. That is right.

Senator CHILES. We do not have that on the corporate structure.

Mr. SLOAN. That is right.

Senator CHILES. Is that fair to those that have a partnership?

Mr. SLOAN. Again, that is why we on the different issue of true tax reform and true simplification are extremely interested in that side of the work you will be doing later this year that that job be done very thoroughly to make sure it comes out in a very fair, equitable way.

Senator CHILES. Doctor, I listened to your statement that you do not want us to be wimpish on spending. You are a pretty bright fellow. If you do not want us to be wimpish on spending and you want us to really put together a package, what if I told you that I can get a lot more spending cuts if I can get a little revenue. Now, do you want me to be wimpish?

Dr. ALBERTINE. I think that is an interesting definition of courage, Senator. On the point you just raised, our effective tax rates, as shown in a study which McKinsey did for us, are about 30 percent.

The effective tax rate of the Fortune 100 firms in America is about one-half of that. So, we have double the effective tax rates of the larger firms.

It is absolutely true that, to the extent to which there are asymmetries in effective corporate rates, it does distort investment decisions. It does misallocate capital, and it does have the effect of slowing economic growth.

However, Senator, we have done a study of the cost of capital in the United States relative to our major trading partners by asset category. Even for equipment which has the best tax treatment, our cost of capital is higher than the cost of capital for our Japanese trading partners.

Mr. SLOAN. Far higher.

Dr. ALBERTINE. Far higher. So that, Senator, even though it would be fair to have a corporate structure which is more even in terms of effective rates, we would worry, although it does not affect our members, about the impact on market share in the capital intensive sector of raising the effective tax rates of firms that currently have very low effective rates. Our cost of capital in the capitol intensive sector is higher than among our trading partners.

LOWER THE COST OF CAPITAL

Senator CHILES. But shouldn't you play on a level field? Should not that field be level for all the players and not different for one set of players?

Dr. ALBERTINE. We would look at it from an international point of view. We would like to play on a level playing field in the United States relative to all our trading partners.

The truth of the matter is, Senator, that if you raise the cost of capital by, for example, eliminating the investment tax credit, and cutting back on the accelerated depreciation, that would have the effect of making the asymmetries in effective rates less great. There is a positive element to that, but it would also have the effect of raising our cost of investment, which is already higher for equipment than it is in Japan.

We fear the result of that would be a loss of market share in the basic industries that I think Senator Riegle would be concerned about, for example, automobiles and others, and that would have the effect of exporting jobs.

So to answer your question on revenues, I think it really is terribly important that we continue to provide incentives in the other direction to lower the cost of capital in the United States relative to our trading partners.

We think that one of the major reasons for our trade deficit is, in fact, that it is still more expensive for us to invest in equipment, in R&D, in land, in inventories and structures, all the business asset categories than it is to invest in Japan or in Western Europe.

Chairman DOMENICI. Senator Kasten.

Senator KASTEN. Thank you, Mr. Chairman.

Let me just briefly respond, Mr. Sloan. One of the things that we are doing in the Kemp-Kasten tax reform plan is to reduce the tax rates on individuals. This is going to have a great beneficial effect on your partnerships and proprietorships.

A lot of your members file personal tax returns for their businesses. When we knock those rates down to 24 percent across-the-board, we give these businesses a tremendous advantage.

PRESENT VALUE EQUIVALENT OF EXPENSING

As you know, Dr. Albertine, with Kemp-Kasten, we are trying to provide the economic equivalent of expensing. That is the direction in which we ought to be moving.

Our depreciation treatment is not front-loaded, but I don't think that really hurts your members since most of them cannot take advantage of all of it in the first year anyway. But I believe that if we can work toward expensing, we can have the kind of growth and competition in capital that you are talking about. By the way, I think we should be concerned about it.

Dr. ALBERTINE. May I just respond? I think I have looked at what you are talking about, Senator, and the truth is you do not have to be completely revenue neutral to lower the cost of capital.

I think we could very well live with the approach you are talking about, the present value equivalent of expensing.

Senator KASTEN. At least it is a step toward expensing, Once established, it is possible that we can help it out over the years.

But I would like to ask each of you a question relating to economic growth, specifically about growth and the money supply. Within the last few days, Paul Volcker said that he intends to supply enough money and credit for 1985 in order for the economy to grow at about 3.5 to 4 percent.

He is assuming that growth will fall in that range. Then he starts to establish his monetary targets. He also indicated that the decline in interest rates would probably not continue. Now, all of you have members who are especially sensitive to interest changes and particularly to the high real rates of interest that we are facing today.

Do you think that Chairman Volcker's range for economic growth is too conservative, and hence money will be too tight?

We will start with Dr. Albertine and I would like each of you to answer as well. Do you think the targets are right in terms of the growth, and second, do you think the money supply is going to be sufficient to provide for the kind of economic expansion that we are looking for?

CONVENTIONAL WISDOM DOMINATING FEDERAL RESERVE THINKING

Dr. **Albertine**. Senator, I think that the Federal Reserve as reflected by that statement continues to underestimate the capacity of this economy to grow. The factors which inhibited growth in the 1970's were high inflation, tax policy which penalized savings and investment, energy prices which were skyrocketing, and a regulatory policy which restricted the ability of business to invest in private output.

And if you look at the situation we now face, I think it is very clear that our potential growth path is significantly greater than the conventional wisdom among economists has suggests, but, unfortunately, the conventional wisdom is dominating the Federal Reserve thinking.

I think it is too low. I think we ought to shoot for a 4½- to 5-percent growth rate in this economy not only in 1985 but for the next 4 or 5 years, and I think it is achievable.

I do think it is important to bring the deficits down, but I think that kind of growth rate is achievable.

Senator **Kasten**. Mr. Smith.

5-PERCENT GROWTH RATE WOULD BE BEST FOR COUNTRY

Mr. **Smith**. Senator, the view of the U. S. Chamber at this point is that we project, assuming some success in approaching this deficit, a 5-percent growth factor over the next 3 years, and while that, in the eyes of some, has been described as being too high, I would suggest that we take our attention back just a few years and look at the mid-1960's.

We could grow 5 percent per year for the next 3 years and not meet the growth rate that we experienced during the 1960's. We sure think that is possible and that is what would be in the best interest of the country.

Senator **Kasten**. Mr. Sloan.

GREATER INFLATIONARY PRESSURE INDICATED

Mr. **Sloan**. Senator Kasten, I think it is particularly interesting to answer this after these two previous responses because we have, just this week, released our quarterly forecast and we are looking for this quarter to have a growth rate in excess of 5 percent.

And we are getting that from basically an optimistic small business community who are still saying that they are adding capacity, adding jobs. It is very interesting, though, because for the first time now in nearly 2 years we saw a new element creep in that was of concern.

We had the highest rate in over 2 years of those responding that they plan raising prices and wage rates higher than usual. That is the first maybe worrisome indication of a greater inflationary pressure than we have seen for a couple of years.

Relating that then to the question of Mr. Volcker's position, is it too conservative, if we, those of you here in the U.S. Senate who are dealing with this terrible problem and those of us who hopefully will be working hard to support you in cutting this deficit, if we get this deficit cut by $50 billion, I think there is no question that Mr. Volcker is definitely too conservative.

If we do not cut the deficit and the Government continues to sop up the borrowing capability, if we grow a lot faster, there is much greater danger of a shortage of available credit and raising interest rates, the thing we all do not want.

Senator **Kasten**. Mr. Chairman, thank you.

Chairman **Domenici**. Thank you very much. I am going to leave and either Senator Kasten or Senator Quayle is going to chair. We have about a half an hour left and one of them can stay.

I wanted to thank all three of you for being here and for your support. I hope we can put something together soon that you can support across this nation. We will need your help.

NEXT DEPRESSION WILL NOT BE EASY TO GET OUT OF

I leave you with this one thought. I know there are things in this budget you do not want to see happen. But, while I am optimistic, I am very worried about the consequences if we do not change current policy substantially and we have a recession. I do not think we are going to get out of that mess very easily.

I think that it is our job to arrange things as best we can. I think you know that if we have a recession, the deficits are apt to be $350 to $400 billion with current policies in place across the board.

I also thank you very much for your consideration and the deliberations on the defense issue. We are all worried about national defense, but clearly discretionary accounts are not growing very fast even using your standards. They are negative in the last 4 years instead of positive on the growth side.

Entitlements are down to 3½ percent, 3.6 percent real growth. That is a whopping improvement over where we started 3 or 4 years ago. Defense has grown about 7½ percent compounded over 4 years, and the one that is most frightening is interest. It has grown 12½ percent per year compounded over 4 years, and that is why we have a real problem.

Thank you very much.

Senator Quayle, I appreciate your chairing for a few minutes.

Senator **Quayle**. Senator Riegle.

SOME FORM OF FREEZE NEEDED

Senator **Riegle**. Thank you, Mr. Chairman.

I have listened with great interest to the testimony and have read it carefully. I agree with the general thrust of what I am hearing in terms of the urgency of reducing the deficit, and I think we got to do it, and I think we are going to need some form of freeze.

The President, as you know, has very forcefully ruled out Social Security. It is not a surprise to any of you. He has spoken about it before the election. He has spoken about it after the election.

He has made the point that Social Security is a separately financed trust fund. The President's words are that we are generating a surplus at present in Social Security. That is not a part of the Federal deficit. That has been his words just within the last several weeks.

So I think he has pretty well taken that off the table, but with regard to everything that is still on the table, I think an across-the-board freeze is something that we need to try to accomplish.

If we can do more than that in selective areas to get the deficit down further, that would be a constructive step too. I agree with the chairman that I think we are courting disaster somewhere out here. No one quite knows where, whether it is 6, 12, 18, 24 months out, but there comes a point at which this fiscal deficit and the trade deficit piled together, I think, are going to be beyond our capacity to sustain.

But I think there is one important sort of missing element in the thinking here today, and I say this as one whose background is on the business side, having worked at IBM for a period of years, and left the Harvard Business School a doctoral program there to run for Congress 19 years ago. So my orientation would be to think about these problems in a similar way to your own.

But I want to ask you a question because I want to have you think about this problem, and that is this, and I am addressing this particularly to you, Mr. Smith. When you talked about the lack of courage in terms of the Congress failing to do the job and the buildup of the deficits and the explosion of the deficits and so forth, and I want to ask you this for the record.

WHAT PERCENT HAS CONGRESS OVERSPENT PRESIDENT'S REQUEST

What would be your estimate over the last four years of the Reagan period, what would be your estimate of what the Congress has actually acted to spend in relationship to what the President has asked us to spend in total amount?

Would you say that we have overspent what he asked by 20, 30 percent? I do not know. I do not want to lead you. I want to hear your notion as to you think is the percentage amount over that 4 years that this Congress has overspent what the President himself has asked us to spend.

Mr. **Smith**. Well, Senator, I do not know without taking a look at my book. I could give you the exact numbers.

Senator RIEGLE. Give me your impression. I want to know what your general sense is, if you do not have the precise number.

Mr. SMITH. If the point, and let me get the point, if the point is one of the admiration of courage on the part of publically elected officials——

Senator RIEGLE. No; I do not want to get off into that. This is a different point I am asking, and I want to know your estimate as to how much you feel the Congress has overspent what the President has asked us to spend over the last 4 years.

Mr. SMITH. Well, as you know from business school, that is a statistic that is available, and I would not want to do it on the basis of feeling. Feeling is not a way to talk about actual numbers.

Senator RIEGLE. No; but is it your feeling that it would be above 10 percent?

Mr. SMITH. I have a feeling, not a feeling a——

Senator RIEGLE. Would you be surprised if you found out it was less than 10 percent?

Mr. SMITH. I have an understanding of the fact that both Congress and the administration in every year have differences of opinion about the expenditure of money.

Senator QUAYLE. Let him——

Senator RIEGLE. No; I do not yield just yet.

Senator QUAYLE. Well, I am the chairman of the committee now, and I am going to ask you politely if you will let the witness please finish his answer to your question. As the chairman I ask you to do that, and I will let the witness proceed.

Mr. SMITH. Thank you, Mr. Chairman.

Having had some experience, having been an elected official and having served on a ways and means committee in our legislative body, Senator, I am familiar with what can be done with facts and figures.

But I think generally what we are talking about when we talk about the courage of Congress, the courage of the Administration or the courage of us in the business field——

Senator RIEGLE. Well, let me just stop you then because you are not answering my question, and I will make the same request then to the chairman. I want to know what your estimate is.

Mr. SMITH. I would be very happy to assure you that we will drop you a line tomorrow and tell you exactly what the numbers are.

Senator RIEGLE. Well, I am not asking you to give me the precise number, because I want to give you the number in a minute because this committee has calculated the number. But what I want to know is based on the thinking that is incorporated in your statement here I got the clear sense that you felt that Congress was wildly overspending what the President asked for.

When I asked you a minute ago if you thought it was above 10 percent, you thought it probably was.

Mr. SMITH. If you were to draw that conclusion from the comments, probably we do not need to talk about the question because that was not included in the comments.

Senator RIEGLE. So you do not think it is necessarily more than 10 percent of what he has asked for?

Mr. SMITH. The thrust of our comment, Senator, was to encouage this committee, to encourage the Congress of the United States who has the authority to appropriate funds for government——

Senator RIEGLE. I understand. You made that clear. I read the statement and I am clear on it.

Mr. SMITH [continuing]. To us our support——

Senator QUAYLE. Senator, would you please let him finish answering the question.

Senator RIEGLE. Well, Mr. Chairman, he is not answering the question.

Senator QUAYLE. You do not have any time clock, but let him finish answering the question.

Senator RIEGLE. That is exactly what I want him to do, Mr. Chairman.

Mr. SMITH. I understood, Mr. Chairman, the question was to what extent has Congress appropriated money in relationship to what the President has asked for over the years, and I said we would be very happy to share those statistics with you formally.

The implication, Senator, was what I was interested in.

Senator RIEGLE. That is exactly what I am trying to get to is the implication because that is why I asked you if you throught, if your impression was that Congress would have overspent the President's request, say, by 10 percent or more, and I had understood you to respond about 5 minutes ago to the effect that you thought that it probably was more than 10 percent or was I incorrect in hearing you?

Mr. SMITH. You were incorrect in making some implication that I was making a comparison between what was asked for by the administration. The thrust of those comments were to suggest that, as a business organization, we were prepared to stand behind those people courageous enough to take some leadership roles in federal spending.

CONGRESS HAS SPENT LESS THAN THE PRESIDENT'S REQUEST

Senator RIEGLE. I understand that. If I may, I mean I understand that and you said that and I appreciate that and you have repeated that several times. But I do not feel, frankly, that you are responding to my question so let me give you the answer because the chairman of this committee has worked it out.

Over the 4-year period, the Congress has spent less than 1 percent more than the President has asked for. Now, I do not think you know that. I mean, clearly it was not something you were immediately familiar with and you were not even comfortable making an estimate.

But most people are surprised when they find that out. I would think most of your members would be surprised, and I would like to ask you to verify that with the chairman of the committee and report that fact back because I think it is a very important one, because the question is if we are not wildly spending money here on whatever over and beyond what the President has asked for, you know, it raises the question of where is all this excessive spending coming from, and it is a very important issue, and it really goes right to the heart of your testimony, and it obviously goes right to the heart of the question of what is going to be the remedy.

But that is the kind of thing I think you have to understand. You have to go back over the 4 years and establish that fact, because if you do not have a clear sense for that, it sort of caves in the foundation of much of the argument that you have made here.

Mr. SMITH. Mr. Chairman, I would submit to the Senator that the thrust of the testimony was not to make a comparison and to give grades to Congress as opposed to the President or the administration in spending.

The thrust of the point we were trying to make in this testimony, and I would make again, is that there exists across the country a frustration with what Government spending levels have occurred.

Senator RIEGLE. I agree with you. We have that, too.

Mr. SMITH. And I would hesitate to try to say this is Congress because we have great respect for many in leadership roles who have taken courageous roles as Members of Congress and the administration.

But we have suggested to the administration in this testimony that they have not gone far enough, and we suggest to Congress that we would like to support those courageous enough to get out and do something.

Senator RIEGLE. I hear you, and I am not trying to suggest that you are trying to put the responsibility one place rather than the other. What I am saying to you is that what we have actually approved to spend over the 4-year period is very, very close to what we were asked to spend.

So there is not a wild divergence here.

Mr. SMITH. I would say, Senator, I hope it is within 1 percent soon, but that that is at a freeze level.

COMPETITIVE CHALLENGE NOT BEING MET

Senator RIEGLE. Let me ask you one other thing. Have you had the chance yet to see the results of the President's Commission on Competitiveness? They announced their findings last week.

Mr. SMITH. I have a copy of that, but I would say I have not done the job I hope to do in studying it.

Senator RIEGLE. I am not going to take you through it because time is short, but I want to recommend one thing to you. These Commission members, of course, were all appointed by President Reagan. This is his Commission, and they just reported back, and the head of the Commission is a man named John Young who was the head of Hewlett-Packard. He may well be a member of one or more of the organizations represented at the table.

I want to just read you one paragraph on page 1 because this is a pretty tough report and findings and a very bold series of recommendations and I would hope you would all take a look at it, because it is a very important document.

They pose the question, "Are we meeting the competitive challenge?" And this gets into the trade issue. And their answer is, "Not well enough. Our ability to compete in world markets is eroding. Growth in U.S. productivity lags far behind that of our foreign competitors. Real hourly compensation of our work force is no longer improving. U.S. leadership in world trade is declining. Even our lead in high technology is slipping."

They take ten categories of high technology world trade products, and they are very interesting to see what they are. We are not talking about cars and steel here. We are talking about aircraft and parts, office computing and accounting machines.

I know you have organizations like that, Dr. Albertine, represented in your group. Engines and turbines, agricultural chemicals and so forth.

They show here that in eight of the ten, we are losing competitive position in the world market. We have slipped dramatically over the period of the last 15 years, and so far I have not heard anybody talk about this.

I had sort of hoped that maybe today some reference would be made to some of these specific things, but I would like to suggest to you in the same way that I am going to take to heart what you have recommended here that you will not only get this but I would hope distribute it to the members of your respective bodies and really take a hard look at the recommendations.

I would like to hear back as to what ones you think we ought to try to do something about, because if we can enlist a consensus on behalf of some of these recommendations, I would like to help make it happen.

COST OF CAPITAL TOO HIGH FOR U.S. FIRMS

Dr. ALBERTINE. Senator, with respect to that report, the heart of those numbers comes from a study which was done by the American Business Conference on the cost of capital in the United States relative to our trading partners.

Senator RIEGLE. Exactly.

Dr. ALBERTINE. We do not have any steel firms in our organization, nor any automobile firms, obviously. If you look at the cost of capital for our major U.S. steel firms in 1965, and compare them to the cost of capital for their Japanese competitors, it is very clear that if they had had the same cost of capital as the Japanese, that industry would be entirely different.

That is also true for the automobile industry. And incidentally, we calculated on an automobile costing $10,000 much of the differential in potential cost and price in the United States comes from the cost of capital.

We also, however, looked at what is going to happen to us in the future if we do not get the cost of capital down. We took a 10-year project, using our figures for 1982 on the cost of capital, and asked what the Japanese would be able to invest in that 10-year project versus what we would be able to invest. The answer is startling. It is about five to one.

We may think we are smarter than the Japanese, but we are not five times smarter.

Senator RIEGLE. You make an excellent point, and as you say that is covered in here. The cost of capital, competitive disadvantage is one of the main areas. Also, the fact that the Japanese are producing twice as many engineers with a smaller population than we are is another thing that bears very importantly on every single business represented here for the future.

But this thing is loaded, I think, with terrific findings that are as important to us, including, by the way, the fiscal deficit is in here as one of the major areas that requires immediate response.

So in any event, I would just urge you to take and really take a look at this and then I would like to hear back from you because let us see if we cannot put together coalition to go out and get some of these things done.

Mr. SMITH. Just in one sentence, Senator, we certainly concur. I am a volunteer, the four industries we are in are turbines, engines, aircraft and aircraft parts, and you mentioned all of them.

Senator RIEGLE. Well, I want to help you sell more of them, help Americans.

Mr. SMITH. Our lack of testimony was not any indication of a lack of interest and a lack of concern and a lack of willingness to do something.

Senator RIEGLE. Thank you.

Senator QUAYLE. Senator Sasser, why do you not go ahead?

NFIB FAVORS ACROSS-THE-BOARD FREEZE

Senator SASSER. Thank you, Mr. Chaiiman.

I want to welcome my old classmate from Vanderbilt University, John Sloan of Nashville, TN. John and I graduated from that university about 4 or 5 years ago so we are still very, very young men by that calculation.

John, I note that you indicated that the NFIB favors a budget freeze in all areas including Social Security COLA's except defense where you favor a 4- percent increase in nominal terms, as I understand it. Is that correct?

Mr. SLOAN. That is correct.

Senator SASSER. You also refer to a survey of NFIB which indicates that about 70 percent of your members favor an overall budget freeze. When you say 70 percent of them favor an overall budget freeze, does that mean they favor a freeze for the total budget including defense or are you excluding a 4-percent increase?

Mr. SLOAN. Well, we presented a general freeze question and the response was as we show on the report. When we go into some of our more localized surveys, we find that, one, an overwhelming response to the question of first a strong defense. Second, an interest that every part of the budget does have to be dealt with, and that is the reason that we are not, well, we believe there needs to be some cutting back in that area as in all others, but that we still do have the support that there should be some modest inflationary growth.

Senator SASSER. And that is the view of NFIB as a result of the poll or not? That is what I am trying to get at.

Mr. SLOAN. The specific of the 4-percent nominal growth is not a part of what was put into the question.

Senator SASSER. I see. So your members favor a freeze across the board.

Mr. SLOAN. That is correct.

Senator SASSER. And you are building in, I suppose, a nominal 4-percent increase in defense because that, in essence, would be a freeze in real terms?

Mr. SLOAN. That is correct.

ABOLISHMENT OF SBA OPPOSED BY NFIB

Senator SASSER. I also note in a quick perusal of your testimony—I apologize for not being able to get here and hear all three of you gentlemen earlier. I have never been able to master the technique of being in three or four places simultaneously which, apparently, is something that stands you in good stead around here.

But I note that the NFIB is opposed to the administration's proposal to abolish the Small Business Administration.

Mr. SLOAN. That also is correct, and that was really the basis of our presenting the NFIB proposal of rather than abolishing the organization, really coming forward with what we thought was a more thorough study for eliminating some programs we do not think have worked well and improving and streamlining others in developing that billion dollar figure as we had the chance before your Small Business Committee yesterday to present that.

We really believe that an awful lot more can be done. We were very concerned, frankly, by Mr. Stockman's suggestion of just selling that $9 billion portfolio for 18 cents on the dollar.

Our best figures say if that portfolio is worked off over a period of years, we can actually save the taxpayers another $5 billion that can be applied toward reducing this deficit.

So we really believe our position will meet our ultimate goal that we are talking about here today, cutting deficits by a greater number than actually Mr. Stockman's proposal.

Senator SASSER. Well, I, for one, want to commend the NFIB. I know last year when we were going through the tough business of trying to deal with the budget deficits last year and Senator Hollings and others and I were supporting them in a bipartisan way, as you know, to try to institute budget freezes that the NFIB and its members across the country were stalwart and stood tall and were calling us and writing us and saying, "Senator, let us do something about this budget deficit, and I hope you will vote for a freeze even though it hurts some things that help me."

So I think the NFIB, if I may say so, comes into these hearings, into this whole arena of doing something about the deficit with clean hands and I think a great deal of credibility as far as I am concerned, and I think that speaks for many of my colleagues.

Mr. Smith, what is the position of the U.S. Chamber on the administration's proposal to cut general revenue sharing? Do you agree with that?

Mr. SMITH. We stand substantially in support—we stand fully in support of the final figures that the President and the administration have suggested in the area of all domestic programs and substantially in support of all those.

Senator SASSER. What is the chamber's view on cutting out the Small Business Administration?

Mr. SMITH. We think that within the Small Business Administration there is room for a substantial decrease in the funds allocated to SBA. I would say, Senator, that we recognize in our recommendations and in our support that there are a good many programs that are very important to many members of the U.S. Chamber but that if this budget discipline that we have been discussing nationally were to be enacted and there were cuts across the board what we are saying in our U.S. Chamber support is that we are willing to take our share of those cuts.

U.S. CHAMBER SUPPORTS PRESIDENT'S RECOMMENDATIONS

Senator SASSER. Would you favor also abolishing the Urban Development Action Grant Program, administered by the Department of Housing and Urban Development?

Mr. SMITH. Well, we have taken the position on the overall freeze and domestic spending and we have generally supported the President's suggestions, but we realize as we move on there may be many areas of negotiation within those, but generally speaking, we do support those recommendations.

Senator SASSER. Has the U.S. Chamber polled its members as to budget recommendations as the NFIB has done?

Mr. SMITH. The U.S. Chamber has a great deal of integrity in its policymaking system, Senator. We have about 1,500 people nationally involved in our 19 policy committees. Those policy committees make recommendation to our board of 65 members, and it is through that function that the volunteers of the U.S. Chamber establish the policy which you hear from time to time enunciated by the staff and in our publications.

Senator SASSER. Well, it is interesting because I have just come back from a full week in my native State of Tennessee, and in getting across the State, I was in a great number of our counties and spoke to a great number of executive directors of local chambers and a great number of chamber members.

I found almost without reservation that they were in opposition to abolition of the general revenue sharing portion of the budget. They supported general revenue sharing. They were concerned about what would happen to local taxes, property taxes, commercial taxes if local revenue sharing was abolished.

I found in-depth support among chamber members for the Small Business Administration, and also substantial support for the Urban Development Action Grant Program which has been very helpful to many of our local chambers in attracting industry and jobs, et cetera, into their communities.

So I asked that question as to whether or not you polled your membership to ascertain how the U.S. Chamber went about developing its position.

Mr. SMITH. I would share with you those decisions. They are very difficult. One balances on one side those desired programs which have been of benefit in the eyes of some to various communities but on the other side we are faced with the recognition that the continuing deficit that exists in the country in the outyears is going to be of more significant detriment to our economic future than perhaps taking a year or two of a freeze in some other programs.

When we recognize what businesses and families have done in the way of fiscal reaction to the pressures these last few years, why, perhaps all of us could take a year of a freeze. You do have to balance those I would admit, and it is often very difficult.

CUT FIRST ON SPENDING END

Senator **Sasser**. Mr. Smith, I well remember around here 2 or 3 or 4 years ago, and I expect my colleague Senator Quayle does also, when Dr. Lesher of the U.S. Chamber was urging the very substantial tax cuts on us of 1981. He was very strong for those tax cuts.

At that time I felt and I think a number of others felt here on this Budget Committee and on some of the other committees that deal with budgetary and fiscal matters, we would have been better advised to go for the spending cuts first.

The easiest thing in the world to do for a politician is to go out and cut people's taxes. They like that and it is the best way in the world to get reelected but it is the toughest thing in the world sometimes to enact these spending cuts.

So I thought we ought to do the cutting first on the spending end, and then we could do the cutting later on the tax end, and maybe we would come out better and do something about the deficit.

But we were assured by representatives of the U.S. Chamber not to worry about that, gentlemen, when we make these tax cuts, you are going to see such a terrific growth in this economy that there is not going to be any problem with revenues and the economy will just grow and like magic will produce these revenues.

We have been waiting now, I have for a number of years. We have seen the economy grow. That is no great surprise. When you engage in a very expansionary fiscal policy, traditionally that has always stimulated the economy, and it did in this instance.

But somehow it has not seemed to have the effect on the budget deficit that we had hoped, and I take it it is still the approach of the U.S. Chamber that we ought to not tinker with the revenue end as far as raising additional revenues but still now we are going to come back and go with the spending cuts again.

MIRACULOUS JOB DONE IN 4 YEARS

Mr. **Smith**. Senator, perhaps we have different views of tax cuts. It would appear to me that we have used an 18- or 19-percent level of our gross national product as revenue collected from our citizens for quite some time and it is going up. It is up to 19.2 percent. When one says tax cuts, we really have not been cutting the revenue of the Federal Government. We moderately increased the extent to which the Federal Government was using their percentage of the gross national product.

On the other side, our expenditure level, we have gone from 19.2 percent of the gross national product used for Federal expenditures, up to 24.8 percent, and there has been a great deal of increase percentagewise on the spending side.

We have not had what one could call massive tax cuts. We have just maintained our percentage of gross national product in revenue. We recall that, at that period, we were talking about high inflation. You remember 12½ percent.

We were talking about interest rates of 21½. We were talking about severe unemployment. We were talking about a lack of new jobs and opportunities for people in this country. We were talkinq about low growth.

What did happen as a result of that program that you mentioned, we have seen this country grow at the greatest rate in this last year that we have seen in three decades. We have seen 7 million new jobs in the last 4 years, private jobs, not public jobs.

We have seen inflation at under 4 percent for 3 years in a row as opposed to that 21½. We have seen more new businesses being developed in this country than we have ever seen. We have seen opportunity for individual citizens. We have seen interest rates come down to half of what they were at that point.

I would say if you ask around this country, or if you ask people who observe us from outside and visit from foreign countries, they would say we have done a miraculous job in these 4 years as a result of those principles that you enunciate, and I am happy we did it.

The disappointment I have is that we cannot keep our spending level where it ought to be in relationship to our revenue levels, and I hope that Congress can recognize we are willing to support that discipline if they will exercise it, the same type of discipline that our Members have been exercising and tough decisions that we have made in our own communities and our own businesses.

INDUSTRIAL BASE BEING DESTROYED

Senator SASSER. Well, Mr. Smith, that is a great speech, and I am sure that goes over well at a membership diive for the chamber, but for those of us who sit here and listen to the economists come in and talk every day it is not quite that convincing.

The unemployment rate today is approximately where it was when you were urging these supply-side economics on us. Real interest rates, that is interest rates corrected for inflation, today are higher than they were in 1981.

One-third of the farmers in this country are in danger of going bankrupt before this year is out. We are seeing American manufacturing firms shutting down nationwide because they simply cannot compete with cheap imports coming in.

We are seeing the industrial base of this country being destroyed in many areas. So there are two sides to this coin which I think we could argue, but I think we will both agree that the deficit has gone up either as a portion of GNP over the past 4 or 5 years or in real dollars corrected for inflation. There is no doubt about that. I do not think there is any disagreement about that, is there?

Mr. SMITH. You know the story the President often tells, Senator, about the optimist and the pessimist with his pony. I tend to think our country is going in the right direction as a result of those economic policies, and that while we do have a lot of room for improvement, we have sure made a more dramatic improvement in the eyes of the majority of the American people and those who observe our economy than we have made in quite some time, and we have made a much greater improvement than other nations of the world.

I think it is a result of the policies that we mentioned earlier.

Senator **Sasser**. I hope you are right. I fervently hope you are right. I expect my time has expired. I might say this. We listened to Chairman Volcker, I think in this committee or maybe in the Banking Committee the other day, and I made the point to him. He has been predicting gloom and doom for years because of large budget deficits, and I told him I have been listening to him now for 8 years, and I have seen the budget deficit grow from $60 billion up to in excess of $200 billion, and I made the same argument to him that you just made to me.

His response was, "Well, things were going great in South America just until a couple of years ago, and when it turned around, it turned around very fast," and the implication was that that was going to happen here unless something was done.

Gentlemen, thank you very much.

CONGRESS HAS SPENT $100 BILLION MORE THAN PRESIDENT REQUESTED

Senator **Quayle**. Thank you, Senator.

Gentlemen, welcome, and particularly Mr. Smith who is one of the outstanding constituents of mine from the great State of Indiana. I appreciate the job that you have done back in your hometown of Muncie, and also the outstanding job you are doing now as president of the chamber of commerce.

Also, I want you to know that a lot of us certainly agree with you that the main culprit on the budget deficit is overspending, which is now taking 24 percent of GNP.

The problem is nobody likes to cut spending. They like to do other things besides bite the bullet on spending.

I might also add that I asked the staff if they could get the figures quickly on how much more the Congress has spent than the President requested in the last 3 years. In 1982, the Congress spent $50 billion more. In fiscal year 1983, they spent $40 billion more. In 1984, they spent $10 billion more. So for the last 3 years, they spent $100 billion more than the President requested.

Now, in Indiana, that is real money. Out here, they just throw $100 billion around and do not pay too much attention to it which is unfortunate. It is probably part of the reason we are in the dilemma that we have.

I have one question I might ask each of you. As we look at these budget deficits in the real world of talking about people that are out there making the decisions on whether to invest, whether to buy, whether to go down and make that purchase, is the fear of inflation still there?

Now, we have had it checked basically for the last 3 years. Many have told us in the hearings out here that, yes; we always have to sort of keep our eye on inflation, but it is not a real threat, not a real worry.

I get a little bit different story back home. I had a number of hearings around the State last week, and inflation was very much on their minds, at least from what I gather. Is the expectation of the return of inflation still a very real fear in business people's minds?

Dr. Albertine, do you want to answer that first?

FEAR OF INFLATION STILL VERY REAL

Dr. **Albertine**. That is an excellent question, Senator.

First, while Senator Sasser did not mention the tremendous progress we have made on inflation since 1981, the fact of the matter is by historical standards we still have a very high inflation rate. We need to do much better on inflation.

Second, I was very interested in Mr. Sloan's survey of his membership, because I think that is very important. I do detect, as well, a sense that, while we won't go back to anything like the doubledigit inflation of the 1970's, we can perhaps expect over the next several years some upward pressure on prices. The major way we ought to be fighting inflation is by making sure that we have a rapid rate of real growth, more goods on the shelves of American businesses.

I think it is very important for the Congress to make some progress on cutting spending, and I was interested in what Senator Sasser said about discussions with Chairman Volcker.

You can agree or disagree with Mr. Volcker's analysis of the economy. You can agree or disagree with my analysis of the economy. The difficulty is that even if Mr. Volcker is wrong in his analysis of the economy, he has a mechanism for bringing about the result that he suggested.

I think it is very, very important that we convince the staff of the Federal Reserve and the Open Market Committee of the Federal Reserve that the deficit is going to come down, so that they can continue to finance a pretty rapid rate of growth.

I think it would be a terrible mistake for the Fed to change course, but I think there is a growing fear of inflation. I think that a pretty good spending reduction package from the Congress would help an awful lot.

Senator **Quayle**. Mr. Smith, is fear of inflation still out there?

Mr. **Smith**. Senator Quayle, I would sense the inflation, that most unfair tax that we have in this country, is a fear. I think it is a fear in most people's minds. I think the change is that there always was an expectation that there was nothing that we could do about it.

I think after 3 years there is beginning to be a recognition that if we do the right things, we may be able to avoid that most unfair tax. I think there is some recognition that perhaps in the sense of expectation that there is a way, and it is not something that is built into the system that we cannot avoid.

Senator **Quayle**. Mr. Sloan?

Mr. **Sloan**. A bit of a different look there. There is no question from what we are hearing from those Members of ours that the deficit is No. 1 on their mind, and the thing is when you ask a followup question is the fear that because there continues to be this deficit that we seem to be consistently spending 5 to 6 percent of GNP more than we are taking in in revenue that someday that has got to come back and bite us in the form of higher inflation.

So that, yes, I think our Members would generally think that is is not licked so long as we still have not really dealt with the deficit.

Senator **Quayle**. Gentlemen, we certainly thank you for your contribution. I am sorry I was late getting here, but I had a chance to read your testimony and we certainly appreciate the efforts that you have made and we will join hands as we try to get ahold of this budget deficit through spending cuts, through spending restraints.

It is not going to be easy. I am sure you had to answer all the questions this afternoon on specific cuts or eliminations and nobody wants to eliminate their particular program. It is always somebody else's program.

Cut off thy neighbor's subsidy but do not touch mine. So we are in for a real whiz-bang of a challenge, but we will certainly attempt to meet it. We appreciate your contribution to our objectives.

Mr. **Smith**. Thank you, Mr. Chairman.

Dr. **Albertine**. Thank you.

Mr. **Sloan**. Thank you.

Senator **Quayle**. The hearing is adjourned.

[Whereupon, at 3:43 p.m., the committee adjourned to reconvene at the call of the Chair.]

WRITTEN QUESTIONS FROM SENATOR KASTEN TO WITNESSES AND THE RESPONSES

Gentlemen, a few days ago, Paul Volcker said that he intends to supply enough money and credit in 1985 for the economy to grow at about a 3.5 to 4 percent rate. He also indicated that decline in interest rates would not continue. Since your members are interest rate sensitive, this should be of some concern to you.

Question 1. Do you think Chairman Volcker's range for economic growth—and hence money and credit—is too conservative?

Question 2. Do you think that a more expansive monetary policy, which leads to lower interest rates, would provide a better economic climate for your members?

RESPONSES FROM MR. BRICKFIELD

Answer 1. We do not think the current Federal Reserve range of monetary growth is too conservative. We think it is about right. AARP has consistently supported the Federal Reserve System in its campaign to reduce inflation, and now that inflation has been reduced it is not time to take a chance on reigniting the inflationary fires. AARP attaches the highest importance to keeping inflation under control, having identified it as one of the principal enemies of the income security of older Americans.

Answer 2. No again. A more expansionary monetary policy would produce at most a brief decline in interest rates. After this they would rise more rapidly than ever, as financial markets became aware that the Federal Reserve policy had changed and alerted their expectations of inflation accordingly. AARP members are interested in policies which promote noninflationary growth.

RESPONSES FROM DR. CARLSON

Answer 1. We believe that Chairman Volcker's goal of real growth of 3.5 to 4 percent for 1985 is consistent with the other important goal of economic policy, long-run price stability. We have seen no evidence of a sudden surge in the growth potential of the U.S. economy. The labor force is increasing about 2 percent per year while productivity is currently increasing at an annual rate of 1.5 to 2 percent; thus allowing for 3½ to 4 percent growth considering labor alone. Manufacturing capacity utilization is at 81 to 82 percent, historically the threshold beyond which bottlenecks leading to inflation begin to accelerate. In fact, it may very well be the case that the noninflationary growth potential of the United States is declining due to the long-run decline in net business fixed investment expressed as a percent of gross national product.

Answer 2. Of course, the real estate industry and the economy in general would benefit from lower interest rates. However, we are of the opinion that attempting to reduce interest rates through a more accommodative monetary policy would be counterproductive. In fact, one of the reasons interest rates are so high relative to current inflation is that both domestic and foreign investors remain wary of the possibility that the United States will succumb to the temptation to inflate our way out of our fiscal difficulties. If the monetary aggregates start increasing beyond their target ranges it is likely to reinforce that suspicion, forcing interest rates even higher. The only way to bring interest rates down is to make the necessary structural changes to federal spending, that is, real defense spending of 3 to 5 percent per year, less than full CPI COLA's for entitlement programs, which will convince the participants in credit markets that over a period of 5 to 10 years Federal spending will approach 19 to 20 percent of GNP, to better match revenues.

RESPONSES FROM MR. TROWBRIDGE

Answer 1. NAM endorses the current stance of monetary policy, and would not support any further loosening or tightening at this point.

For 1985, the Federal Reserve has retained its 47-percent target for MI, and has slightly raised the operating targets for its other monetary aggregates. Given an inflation rate in the range of 4-percent, these monetary targets are consistent with a growth rate of at least 4-percent, and perhaps even 5-percent in real GNP. For this reason, the Federal Reserve targets are probably not excessively restrictive.

Answer 2. With respect to interest rates, the Federal Reserve's less accommodative strategy during 1984 ultimately contributed to the decline in interest rates toward the end of the year. The rise in interest rates during the middle of 1984 occurred largely due to increased credit demand associated with higher economic growth. By refusing to accommodate the surge in growth, the Federal Reserve demonstrated its intent to not rekindle inflation, which helped to reduce interest rates by curbing inflationary expectations.

It should be noted that the average level of real interest rates over the last few years is a result of the combination of a highly expansionary fiscal policy and a noninflationary monetary policy. Taking this into consideration, NAM endorses greater fiscal restraint as the most important policy option for reducing real interest rates. A more expansionary monetary policy would likely lead to higher nominal interest rates through a rejuvenation of inflationary expectations.

STATEMENT BY THE
AMERICAN PUBLIC TRANSIT ASSOCIATION

FOR THE

COMMITTEE ON THE BUDGET

UNITED STATES SENATE
HONORABLE PETE V. DOMINICI, CHAIRMAN

MARCH 7, 1985

Statement of the
American Public Transit Association
For the
Committee on the Budget
U.S. Senate

March 7, 1985

INTRODUCTION

The American Public Transit Association represents over 300 bus and rail transit systems across the country which carry 94 percent of all transit riders in the United States. In addition, APTA's membership includes over 400 manufacturers and suppliers of transit equipment, consultants, contractors, state and local departments of transportation, planning agencies, and universities.

We are pleased to present the Committee with our views on the absolutely crippling effect which the Administration's proposed 1986 transit budget will have on communities across the country. In the past appearances before various committees of Congress we have decried massive reductions and the elimination of federal transit funding on a variety of well-supported grounds. In its wisdom Congress has consistently reinforced its commitment to meeting the mobility needs of the nation by resisting the efforts of the Administration to gut the federal transit program. This year, however, we are faced with perhaps the most blatant and devastating attempt yet to kill the federal transit program.

Where the Administration's past efforts were centered on 'phased' reductions, the FY 1986 budget proposal eliminates entire programs in a single sweeping gesture; where past rhetoric has at least acknowledged Congress' consistent intent to maintain the federal transit program, this budget presumes to unilaterally redefine and eliminate the federal interest, disregarding Congressional intent; where meager attempts were made in past budgets to provide some rationalization for proposed reductions, the proposals for FY 1986 are based only on vague philosophy and an occasional anecdote. No decision-maker, public or private, would make even the most routine investment decision based on such superficial rationales and disregard for the impacts, much less a decision affecting the mobility of millions of Americans and the economic vitality of our nation's communities.

We, as well as our colleagues in state and local government, welcome the opportunity to discuss with members of the Subcommittee the inequity and the devastating impacts of an attempt to reduce a $200 billion annual budget deficit by seeking massive cuts in domestic programs which represent only 10 percent of the budget. The deficit must be reduced--we all share this common objective--but there must certainly be a means of achieving the objective in a much more well-reasoned, well-balanced and less disruptive way.

The basic points we wish to make are these:

1) Transit investment needs are sizeable and continue to grow;

2) The Administration's proposal to withdraw federal support is highly unfair and the rationales provided incorrect and misleading;

3) The greatest impacts will fall on the most vulnerable members of our society--the low income riders, the transportation disadvantaged, the elderly, etc.;

4) Transit services in hundreds of communities will suffer immediate, unavoidable and massive declines;

5) There will be substantial negative economic impacts;

6) State and local government are not in a position to replace massive reductions in federal transit support to avoid these consequences;

7) Some balance and equity must be restored to the effort to reduce the deficit; a freeze in domestic programs is a legitimate and productive approach without the disruptive, divisive and unfair consequences that clearly will result from the Administration's proposal.

TRANSIT CAPITAL INVESTMENT NEEDS

Last February, we presented to Congress the results of a detailed assessment of the nation's transit capital needs. The analysis indicated that a total capital investment of over $36 billion is required through 1988 to ensure the continued integrity, safety and reliability of service to the public. Table 1 indicates how these needs are distributed among major types of projects.

Table 1
FIVE YEAR TRANSIT CAPITAL NEEDS

Project Type		Capital Needs[1]	Percent
Bus		$ 7,725	21.2%
Facilities	$ 3,929		(50.9%)
Vehicles	$ 3,796		(49.1%)
Rail		$28,730	79.6%
Modernization	$15,088		(52.4%)
Extensions	$ 3,783		(13.1%)
New Starts	$ 9,859		(34.3%)
TOTAL		$36,455	

[1] 1984 dollars in millions

The critical findings which have emerged from this assessment, and which were presented in detail one year ago, are:

-- Nearly $8 billion will be needed to meet the capital requirements of the nation's bus systems;

-- Bus capital needs are equally split between vehicle replacement requirements and maintenance facility improvements;

-- 30 percent of the bus fleet is past its economic life (12 years); 33 percent of the nation's bus maintenance facilities are over 40 years old;

-- Modernization of our nation's older rail transit systems requires over $15 billion. Even current levels of investment are inadequate to substantially reduce the backlog of modernization needs; continued under-investment may lead to major declines in reliability and safety, and possible system failures in the near future;

-- Nearly 30 percent of the rail car fleet is past its economic life (25 years); 56 percent of the nation's rail maintenance facilities are over 40 years old;

-- Over $13.6 billion is needed to support new rail system and high capacity fixed facility development over the next 5-years; over 30 projects in more than 20 areas around the country are now in formal planning or design to meet otherwise unserviceable travel demands.

The analysis of capital investment requirements over the 5-year period indicated that the majority is needed to address existing needs--over 80 percent of the $36 billion required is needed to properly upgrade already existing facilities and equipment or to provide basic levels of service to meet already existing travel demands. It is also our understanding that the 5-year $36 billion figure is generally consistent with UMTA's own assessment of overall transit capital investment requirements. The similarity of these estimates will be more closely confirmed when UMTA releases the results of the rail modernization study requested by the Senate Appropriations Committee in 1982. It is our understanding that final cost estimates associated with the modernization of existing rail transit systems are very nearly completed.

The ample evidence assembled and presented over the past year on the scope of transit capital needs in this country should, by itself, serve as an adequate indicator of the devastating impact of the Administrative's FY 1986 budget proposal. Yet capital investment is only one part of the picture.

OPERATING REQUIREMENTS

The cost to operate and maintain essential transit services in this country now exceed $10 billion annually. Our most recent estimates, shown in Table 2, indicate how the overwhelming share of this burden - over 90 percent - is already being born by those who benefit directly and indirectly, the riders and state and local tax payers.

Table 2
SOURCES OF SUPPORT FOR TRANSIT OPERATIONS AND MAINTENANCE

Source	Amount	Percent
Fares and Other Earned Income	$ 4.45 bil	44.1%
State and Local Assistance	$ 4.78 bil	47.3%
Federal Assistance	$ 0.87 bil	8.6%
Total	$10.10 bil	100.0%

1984 estimate.

The 10 percent overall federal contribution masks some critical factors which lie at the heart of why the federal contribution is absolutely vital and must be maintained:

-- Smaller systems are often dependent on federal operating assistance to meet 30-40% of their costs. It is these systems and services that are in greatest immediate jeopardy from a total federal withdrawal; it is these areas that are frequently without the tax base to replace lost federal funds; it is these systems that serve a larger share of low income, transit-dependent users who have few, if any, options to maintain their mobility;

-- In large systems, federal operating assistance frequently accounts for 10 percent or less of revenues, but represents large actual amounts of aid--frequently tens of millions of dollars or more; It is just as difficult, if not impossible, for these areas to replace such large amounts of lost federal aid as it is for small areas to replace the high percentage;

-- Operating funds are the sole source of support for maintenance activity; if adequate and timely maintenance is to be performed, adequate support for operations must be maintained; if the federally -supported capital investments are to be maintained there should be a parallel federal commitment to the maintenance of that investment;

-- In many important instances, increases in transit operating costs are the result, directly or indirectly, of federal requirements and mandates; because these requirements, for the most part, represent worthy national policy objectives, it is reasonable to expect some level of federal support to carry them out.

Transit systems and local officials have achieved considerable success in recent years increasing productivity and controlling costs through a variety of managerial, organizational and service innovations. Intergovernmental support of transit operations at the local, state and federal level has made this possible. Wholesale withdrawal of the federal partner will destroy these achievements and hasten an immediate, unavoidable and massive decline in the extent and quality of basic transit services.

THE FY 1986 BUDGET PROPOSAL FOR TRANSIT

The Administration's FY 1986 budget proposal for transit is now well understood by the industry, local officials and members of this Committee. It effectively represents the total withdrawal of the federal government from the transit program, the abandonment of millions who rely on transit daily, and a broken faith with Congress and local officials over the principles and provisions of the Surface Transportation Assistance Act of 1982 (STAA).

Before assessing the specific impacts of the proposed transit budget, it is worthwhile to briefly outline, for the record, its essential elements. The budget proposes:

1) Slashing overall UMTA funding from $4.1 billion to less than $1.4 billion in a single year--a 67 percent reduction;

2) Slashing major program funding under Sections 3 and 9 from $3.57 billion in 1985 to $1.1 billion in 1986--nearly a 70% reduction;

3) Total elimination of all federal support for operations, maintenance and administration in 373 urbanized areas and 974 small urban and rural systems;

4) Reductions in direct formula capital assistance to 373 urbanized areas of over $400 million;

5) Total elimination of $25 million in capital funding for 858, non-profit providers of service to the elderly and disabled under the Section 16(b)2 program;

6) Reductions from $72 million to $32 million in capital assistance to 974 small urban and rural systems under the Section 18 program.

7) Elimination of $1.1 billion in discretionary capital funding for new systems, rail modernization and major bus projects, and a flat prohibition on any new system development.

It should be no mystery how these massive, immediate reductions will affect transit riders, the communities they live in and the systems that serve them.

There is another dimension to the proposed cuts in transit funding, however, which even better illustrates how the burden of deficit reduction is being placed on transit riders and state and local governments:

1) The proposed transit budget presents barely 1/10 of one percent--.0012--of the federal budget. Yet the proposed cuts of $2.8 billion represent nearly 5½ percent of total spending reductions being sought. Transit cuts are nearly 50 times larger than transit's share of the budget.

2) In 1985 transit represented only 14.3 percent of total transportation spending; the proposed budget would reduce the transit share to 5.6 percent, abandoning any pretense of balanced transportation investment.

3) Total transportation spending is proposed to be cut $3.7 billion; total transit funding is proposed to be cut $2.8 billion. Transit cuts account for nearly 75 percent of the total cuts in transportation.

This type of gross imbalance in attempting to reduce the deficit is both unfair and unwise. It reflects a callous disregard for the needs of our citizens and applies totally unjustifiable double standard with regard to which programs and beneficiaries will be made to sacrifice and suffer.

Administration Rationales

As suggested earlier, there is very little in the way of well-reasoned or well-constructed rationale for what is being proposed in the fiscal 1986 transit budget. Administration documentation provided to Congress in support of the budget proposal contains only general philosophical themes that have been heard before and have proven to be unsupportable, and occasional anecdotes which in no way accurately reflect or characterize the transit industry.

The heart of the rationale is a vague intergovernmental philosophy left over from the Administration's new, "new federalism" concept which states there is no federal interest or role in transit, that transit is a strictly local matter. Both history and recent actions by the Administration itself clearly indicate the reverse:

-- For twenty years, the federal government has articulated, refined and reinforced the significance of transit and the vital nature of the federal interest. The statutory objectives and purposes for the transit program are built around issues of undeniable and broadly accepted national interest, both social and economic;

-- Transit providers are called on directly by law and regulation to ensure the achievement of worthy national policies, often at considerable added cost. Buy America, civil rights, environmental protections, minimum wages and guarantees of service as well as low fares to the elderly and disabled are just a few examples;

-- Finally, despite the vague insistance by OMB that there is no federal interest or involvement in local transit operating decisions, this Administration's own Justice Department went to the Supreme Court to insist that federal wage requirements under the federal Fair Labor Standards Act be applicable to transit, since transit was not, in their eyes, a traditional function of local government.

It is ironic also that other of the Administration's proposed FY 1986 budget actions will significantly increase costs to transit operators at the same time federal support is withdrawn. The proposal to withdraw federal support from AMTRAK--a questionable proposal in its own right--will automatically add over $82 million to the budgets of four major east, coast systems who must take over operations on portions of the Northeast Corridor.

It should be obvious that the philosophy on which this budget is based is simply wrong and, more to the point, strongly contradicted by the deeds of the Administration itself.

A second general rationale for gutting the UMTA program is that the presence of federal funds has caused inefficiencies and cost increases in transit service delivery. Without belaboring the point, the reverse is, in fact, the case.

Major facts to consider are these:

-- As the federal transit program grew to its peak from the early 1970's to 1980, transit ridership grew 26 percent, basic services were rescued from collapse in hundreds of communities and fares to the rider were maintained at reasonable levels in response to specific Congressional directives;

-- With respect to control of labor costs, from 1976 through 1984, the percentage wage increase for bus operators has been equal to or less than the wage increases of other workers under major labor contracts for every single year. This occurred while the federal operating program grew to its peak and while ridership reached its all-time, post-war high;

-- During the period 1970 to 1975, before the federal operating program was instituted, productivity measures were in the decline; from 1975 through 1980, coincident with the growth in the federal program, productivity measures show major improvement (1):

	1970-1975	1975-1980
Passengers/Employee	- 7.6%	+ 14.4%
Passengers/Vehicle Mile	- 2.0	+ 18.0
Vehicle Miles/Employee	- 5.7	- 3.1
Operating Expenses (Constant $)	+ 36.6	+ 5.0
Expense/Passenger (Constant $)	+ 36.0	- 14.9
Expense/Vehicle Mile (Constant $)	+ 33.3	+ 0.5

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(1) Based on analysis of 44 systems representing 65 percent of national vehicle miles of service and 70 percent of all passengers carried.

The claim that federal support has caused declines in productivity and efficiency is simply incorrect. Federal support has promoted increased ridership, increased productivity and ensured basic levels of mobility throughout the country.

A third general rationale for slashing the transit program is the claim that support is unwarranted because direct users do not pay fully for the service they receive and that the program predominately serves high income, white collar, suburban commuters. Again, several points can be made:

-- Direct transit users pay 40 percent of the operating cost through the fare box; indirect beneficiaries--state and local residents--pay another 47 percent; nearly 70 percent of the UMTA program is equitably returned to areas via a formula which is based on population and extent of service in the region. Users and beneficiaries are paying their fair share and receiving a fair contribution from the federal program and receiving a fair level of support from the federal program.

-- A narrow user-fee philosophy should not be the primary test of the need for or legitimacy of programs or policies, as the DOT budget implies. A host of major programs of long-standing federal interest require citizens of one region to support the needs of citizens in another, all to achieve undeniable national social and economic goals, e.g. non-consumers support tobacco and other agricultural subsidies; childless couples and individuals pay property and other taxes to support education; the midwestern farmer's taxes support coastal zone management and coast guard activities. The list can go on and on and would include the fact that more populous states heavily subsidize the extensive federal aid highway costs of less populous states. Even in the private sector, cross-subsidies frequently exist among productive units of a single organization.

We are a highly integrated society in our social, economic and governmental interdependencies. Major federal policy, budget and investment decisions driven totally by a user-pays mentality are naive, disruptive and divisive.

-- Transit is decidedly not a service catering predominently to the high-income, white collar suburban commuter. Up-to-date figures on the profile of today's transit riders are provided in the following section in order to clearly demonstrate the broad ranging characteristics of today's transit riders and the substantial core of riders that is low-income, transit-dependent or otherwise disadvantaged.

As a final point in the Administration's rationale for withdrawing support for public transit, we have noted a statement suggesting that, 'the mass transit problem has been partially solved.' One need look no further than the data summarized on page 3 in this statement on the current condition of our nation's transit facilities to see the absurdity of such a statement. Even at current levels of support from the federal government, the existing backlog of critical transit investments cannot be substantially reduced. To withdraw, claiming victory is an insult to the Congress, the transit industry and, most important transit riders.

Again, the Administration's entire budget proposal for transit rests solely on vague philosophy and occasional anecdotes that are gathered together to intentionally misconstrue the facts and mislead the reader. There is no credible rationale whatsoever to support the immediate, massive cuts proposed for transit and virtually no acknowledgement, understanding or apparent concern over the impacts.

IMPACTS OF THE PROPOSED TRANSIT BUDGET

That the impact of immediately reducing federal support for transit by 70 percent would be disasterous for riders, communities and business should surprise no one. Transit systems as well as state and local governments operate on the margin, with virtually no cushion to absorb the kinds of reductions being proposed, either in the transit program or in the host of other domestic programs slated for major cuts or elimination.

The impacts can be characterized in a variety of ways, by looking at who the riders are that will be harmed most, by looking at the likely impact on actual transit services and by looking at the impacts on the economy and business community.

Who Will be Harmed?

The primary mission of public transit is to provide a basic level of mobility to those who have no other means of travel and to provide effective options to those who do. In serving these two people-oriented objectives our broader social and economic objectives are served as well.

A host of misconceptions exist about who uses public transit. Many of these misconceptions are being fed by the Administration in its attempt to use anecdotal information to inaccurately characterize public transit. One example is their suggestion that public transit predominately serves the commuting needs of high income, white-collar professionals. This is totally inaccurate and, in fact, directly contradicts estimates made by the Department of Transportation itself.

The truth of the matter is that public transit serves the broadest possible spectrum of needs and people. More importantly, the core of today's ridership is composed of those who are wholly or highly dependent on transit for their basic mobility. Transit is, in a very real sense and always has been, a critical part of the 'social safety net.'

Results of ongoing survey efforts among transit systems across the country graphically demonstrate the degree to which transit is a basic lifeline for the low-income and disadvantaged. Even the Administration's own assessment of transit ridership characteristics strongly supports the figures noted below. (2)

Recently assembled ridership statistics from 140 transit systems which operate over 75 percent of the nation's transit vehicle fleet Reveal the following ridership profile:

-- 60% of transit's riders have incomes under $20,000 per year; 33% have incomes under the poverty level of $10,000 per year;

-- The Administration's own estimates are even higher--71% under $20,000 and 40% under $10,000;

-- 28% of transit's riders are in age categories (under 16 and over 65) with limited access to automobiles and/or diminishing ability to use them;

-- 16% are over 65 years old, a population group expected to grow substantially in future years;

-- Administration estimates closely parallel these figures on age of riders;

-- Nearly 60% of transit riders are female;

-- Nearly 40% are minority;

-- 54% of trips made on transit are made for work purposes, reinforcing the economic significance of transit for both employees and employers;

-- The remaining 46% are for a variety of non-work purposes, including shopping, personal business, medical social, etc., indicating the role of transit in supporting the social and cultural fabric of the nation.

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(2) See assorted tables, pp. 25-31, contained in the Administration's report to Congress, "The Status of the Nation's Local Public Transportation: Conditions and Performance," Report of the Secretary of Transportation to the U.S. Congress, pursuant to Section 310 of the STAA of 1982, submitted in September, 1984.

In looking at this brief profile of transit ridership it should be clear that public transit is an essential service both socially and economically. If the drastic cuts proposed by the Administration are enacted, the largest share of the impact will be born directly by those least able to cope. The social safety net has already been stretched to the breaking point. Eliminating transit aid and unraveling the few threads that remain would be an unconscionable act of total disregard for the needs of our nation's most vulnerable citizens. The question of fairness is central to a discussion of the transit cuts.

What are the Impacts on Systems and Services?

The direct and immediate impacts of the Administration's proposed transit cuts on riders are driven, in large part, by the direct effect on transit systems and services.

APTA member transit systems were surveyed on the likely impacts of the proposed cuts. Survey results from over 150 systems which carry 75 percent of the nation's transit riders are unequivocal--the impacts will be devastating, they will be immediate and they will be broad-based. It is absurd for anyone to suggest, that the results of an immediate 70 percent reduction in funding could possibly be otherwise.

In general terms, the survey indicated that riders will be stranded by the millions, including transit-dependent, elderly, handicapped, low income and those too young to drive, as well as workers who have until now, been able to leave their cars at home. Badly needed rehabilitation and maintenance investments will be delayed or foregone entirely, precipitating rapid declines in service quality, reliability and safety.

Major new capital investments badly needed to serve rapidly growing areas of the county where street and highway networks are already over capacity will be indefinitely delayed or abandoned. Massive service cuts will be inevitable with a considerable number of local area systems, both large and small, facing complete collapse. Where services can be retained, fares would have to be raised immediately, often to unprecedented levels just to maintain even skeletal levels of service.

Drastic impacts from the proposed cuts are no longer limited to smaller systems which have traditionally been more dependent on federal support. Transit systems, of all sizes, their riders and the communities they serve, including many of our nation's major metropolitan areas will be dramatically effected.

Although transit systems were not asked directly if they would shut down, nearly 20 percent noted specifically, on their own, that a shutdown was an imminent possibility. Fully 90 percent used terms such as "catastrophic," "dramatic," "drastic," etc. in characterizing the effects of the proposed budget cuts in their region. Details from the survey are highlighted below.

o When asked about the impact of total elimination of federal operating assistance, transit systems indicated:

- 88 percent will be forced cut service dramatically;
  - 7 of every 10 systems will cut services more than 20%
  - Nearly 1 in 3 systems will cut service more than 50%
  - 1 system in 7, mostly in smaller areas under 200,000 population, will cut service 90 percent or more;
- 82 percent will be forced to raise fares substantially;
  - Nearly ¼ of those, mostly small systems, predicted increases of 90 percent or more;
  - Nearly ½ projected increases of 50% or more;
  - These increases will occur on top of a national average base fare of nearly 60¢, currently;
- 87 percent anticipate major declines in ridership; 6 of every 10 systems predict ridership losses of 20% or more;
- the percentages of systems expecting major fare increases, service cuts and ridership losses was consistent among systems of varying size;
- 78 percent anticipated substantial reductions in mobility for transit-dependent populations in their areas; direct effects on elderly, handicapped, low income and the young were noted consistently in areas of all sizes;
- Nearly 2/3 predicted tangible, negative impacts on their local economies.

o When asked about the impact of major reductions in federal capital assistance, transit systems indicated:

- 70 percent would be forced to forego the purchase of new bus vehicles;

  This, despite the fact that over 30 percent of the nation's transit bus fleet is past its useful economic life of 12 years.

This response alone could kill the nation's domestic bus manufacturing industry, already on brink of disaster from 4 years of threatened federal withdrawal which has reduced the U.S. transit bus market from nearly 4,500 vehicles per year in 1981--the level necessary to replace over aged vehicles--to less than 2,000 in 1984.

-- 30 percent would be forced to forego vital rehabilitation or replacement of maintenance facilities;

This, despite the fact that:

-22 percent of the nation's bus maintenance facilities are over 60 years old;

-33 percent are over 40 years old;

-17 percent have severe capacity restrictions even at current operating levels;

-- 5 regions would completely forego rail system construction;

-- 5 existing rail systems would be forced to forego urgently needed major rail modernization activity.

o The result of greatly reduced federal capital investment will exaggerate the overwhelming impacts of the elimination of operating assistance:

-- 58 percent indicate service levels will be further reduced by capital funding reductions;

This effect is stronger in medium and larger areas where 68 percent of the systems responding note service reductions stemming from the loss of federal capital funding.

-- 60 percent foresee declines in the quality and reliability of service, in addition to reduced levels of service;

-- 84 percent of the larger systems project decreases in service quality;

-- 63 percent note that their ability to maintain equipment will be adversely affected by reductions in capital funding.

What are the Economic Impacts of the Cuts?

The impacts of the Administration's proposed withdrawal from the federal transit program extend well beyond the direct effects on riders and services. Massive reductions in the transit program will impact every segment of the economy. Without question, the reductions will be counter-productive to the achievement of further economic growth and will create a drag on economic performance of which the Administration is apparently unaware.

Based on detailed analysis of the economic impact of transit investments carried out by APTA in 1984 using Commerce Department data and models, the following impacts are projected:

- For each $100 million of capital funding lost,
  - a loss of 7,600 jobs;
  - a loss of $327 million in business revenues;
- For each $100 million in operating support lost,
  - a loss of 9,600 jobs;
  - a loss of $305 million in business revenues.

The aggregate impact of the Administration's proposed transit cuts would, therefore, cost 203,000 jobs and a loss of $8 billion in private business revenues.

Private businesses which supply goods and services to the industry were also asked what impact the Administration's transit budget cuts would have on their businesses. These results serve to reinforce the counter-productive nature of the proposed cuts in terms of fostering national economic stability and growth. Of the manufacturers and suppliers surveyed:

- 70 percent view the proposed capital cuts as "severe" or "disasterous" for their business;
- 46 percent anticipate plant or office closings as a result of capital cuts;
- 87 percent project layoffs averaging 13 percent of their present personnel;
- 73 percent project immediate, direct revenue losses of over $300 million, or close to $1 billion if multiplied throughout the entire economy;
- 45 percent anticipate withdrawal from the urban transit market.

The perspective that is absent in the Administration's philosophy has been articulated most eloquently by members of

Congress, local officials and state officials in recent weeks. That is, support of domestic programs generally, aid to state and local governments and assistance for public transportation specifically, should be viewed as fundamental investments which are essential to support our nation's social and economic structure in ways that are every bit as vital as our defense expenditures. Investment in public transportation must continue to be viewed as part of the solution rather than part of the problem; failure to do so and the precipitious withdrawal of support for domestic programs like transit will only serve to increase our problems.

Based on the survey results summarized above, reductions of the scope being proposed for the transit program will cause drastic reductions in mobility, weaken our general economy and possibly destroy our domestic capability to meet future mobility needs.

SHIFTING THE BURDEN TO STATE AND LOCAL GOVERNMENT

Much of the recent rhetoric concerning major cuts in domestic programs and assistance to state and local governments revolves around claims by the Administration that state and local budgets are showing surpluses that can accommodate the withdrawal of federal support. Without going into detail it appears as though the arguments and analysis offered by the Administration have been refuted by state and local officials.

Based on comments of APTA transit system members and manufacturing members, as well as the information now available from state and local officials, it is obvious that massive federal cuts cannot be made up from state and local sources.

. In our survey of the transit industry, we pointedly asked whether the proposed transit cuts could be replaced from other sources. The results are clear--they cannot. Almost nowhere, either among transit system operators or businesses serving transit systems, is there a realistic expectation that any combination of increased local, state or even private funding can replace the near total elimination of federal support:

-- 90 percent of the transit systems surveyed said neither local nor state sources individually could replace lost federal operating or capital assistance;

-- 79 percent said the combination of local and state sources could not replace lost federal operating aid; 90 percent said the combination could not replace lost capital assistance;

-- Most telling of all, when asked if combined local, state, and private sources could make up the federal cuts, 77 percent said 'no' with respect to operating aid and 86 percent said 'no' with respect to capital funding.

-- 89 percent of the manufacturers and suppliers of transit equipment and services do not believe local and state governments will be able to replace lost federal capital aid.

These are strong, near-unanimous sentiments from careful observers of the state and local scene. These views are reinforced in recent analyses of the fiscal condition of state and local government done by the National Governor's Association, the National Association of State Budget Officers, the National Conference of State Legislatures, the National League of Cities and the U.S. Conference of Mayors. Their representatives will, no doubt, provide the Subcommittee with a more detailed and compelling review, but the key facts are these:

-- State 'surpluses' have increased largely because of emergency tax measures and emergency service cuts enacted during the depths of the recession as a matter of prudent and responsible management of a major fiscal crisis;

-- Continued sound and responsible management will require these actions be reversed and basic service levels be restored before new responsibilities can be shouldered;

-- The end-of-1984 state 'surplus' was $6.3 billion, 3.9 percent of budget. This is still substantially below the 5 percent figure Wall Street deems a safe, prudent margin;

-- Only 18 states had a 'surplus' over 5 percent at the end of 1984; only 8 states accounted for half of the 'surplus;'

-- The projected 'surplus' will fall in 1985;

-- With respect to transit, of the 18 states with a 'surplus' over 5 percent, only 4 can be considered major transit states;

-- The largest 'surpluses' occur in states typically without major transit needs; the states where transit needs are greatest, have the smallest 'surpluses'.

City and county governments are in no better position than the states to absorb the huge transit cuts being proposed. Their revenue collection capacity is severely constrained in the vast majority of cases. Ironically, it may be further constrained by the emerging tax policy of this Administration which would either eliminate various financing options or raise their cost to local government significantly. In the mean time local governments continue to struggle in meeting the public facility and service needs of ever-growing central city populations of the poor, the unemployed, the hungry and the homeless.

It is clear for the time being, that state and local officials, including transit managers and policy makers, have sacrificed and struggled to retain basic levels of public service. Rather than reward these achievements and insure that basic public services like transit remain in place, the Administration's budget is punitive, further punishing those who have already sacrificed the most. The result will not be a replacement of lost federal aid, but a further wholesale decline and elimination of essential public services, transit among them.

TRANSIT'S PAST CONTRIBUTION TO DEFICIT REDUCTION

Public transit operators and riders have made a substantial contribution to deficit reduction since the current Administration took office in 1982. Appropriations for the major federal transit programs totaled $3.718 billion in 1981 ($4.462 billion in 1985 dollars). Last year actual appropriation levels for these programs totalled only $3.570 billion. In 1985 dollars, transit funding has been reduced $892 million since 1981--a 20 percent reduction and nearly a billion dollar contribution to deficit reduction.

In addition, $1.2 billion in gas tax revenues accruing in the Mass Transit Account of the Highway Trust Fund will have been denied to transit systems by the end of 1986 under existing obligation limitations. Inability to utilize these funds brings the total transit contribution toward deficit reduction over $2.0 billion if 1986 funding were frozen at 1985 levels.

If other programs and budget functions had made similar contributions, there likely would be no deficit problem today. Constructing a fair and effective budget for 1986 should include consideration of the substantial contributions already made in a variety of federal programs, including transit.

SUMMARY

Congress was wise in the development and passage of the Surface Transportation Assistance Act of 1982. We continue to believe that the STAA represents an important, forward-looking and reasonable federal commitment to the long-standing transit partnership--a commitment that can be fulfilled in concert with both social and economic goals and the need to achieve reductions in the deficit.

It is regrettable, however, that the Administration has chosen to support only selective portions of the law and to disregard the language and intent of other sections. Contrast the testimony of FHWA officials on how proud and responsibly the Administration is fulfilling the highway provisions of the STAA with the total disregard of OMB, UMTA and other top Administration officials for the transit provisions. The Administration's budget, in fact, cannot be implemented without passage of authorizing legislation that would gut Title III of the STAA.

We fully support and applaud the efforts of the Administration to live up to the highway provisions of the STAA. But what is sauce for the goose should be sauce for the gander. We desire, as I am sure members of Committee desire, nothing more than adherence to the intent of the law and good-faith actions to carry out that intent fully, and in a timely manner.

In closing, we look forward to supporting the Committee in development of a fair and equitable budget proposal that retains the essential federal role in the 20-year intergovernmental transit partnership. We urge the Committee to flatly reject the Administration's budget proposal for transit in the search for a more balanced and well-reasoned approach.

Finally, in the long-term, we anticipate working closely with Congress in shaping a transit reauthorization proposal that can both sustain the federal role in support of transit and can assist in reducing the budgetary impacts of the transit program at the federal level.

We appreciate the opportunity to provide these comments to the Committee for its consideration.

STATEMENT
on behalf of the
California Association of REALTORS®
regarding
First Concurrent Budget Resolution for Fiscal Year 1986
to the
Senate Committee on the Budget

by Raymond D. Spinelli, President
February 28, 1985

This statement, regarding the First Concurrent Budget Resolution for Fiscal Year 1986, is submitted by the California Association of REALTORS® in conjunction with the testimony filed by the National Association of REALTORS® on February 22, 1985. The California Association of REALTORS® (the "Association") is a trade association representing over 100,000 real estate professionals in the state of California whose business activities involve assisting consumers in the buying and selling of real property. In particular, our members are predominately involved in assisting households in meeting their homeownership objectives through the purchase of single-family housing.

The Association wishes to strongly echo the concerns shared by all Americans on the current and growing budget deficit. We share the belief that our nation's economic health cannot be sustained without a permanent resolution of this enormous problem. In that housing and real estate represent perhaps the most credit-sensitive sectors of our economy, our heightened alarm over the persistent deficit is readily apparent.

The Association has in the past supported a whole series of efforts designed to correct the budgetary short-falls of recent years. We will continue to support all reasonable efforts to achieve an end to deficit spending at the earliest feasible time. In this context, we recognize this Committee's efforts to address this issue and commend all those in the Administration and the bipartisan leadership of the Senate in attempting to reduce the projected deficit in Fiscal Year 1986 and beyond.

We thus share the collective objective of substantially reducing the deficit; however, we would be remiss in not relating our ongoing concerns that budget policy actions should be consistent with the long-standing national goals of increasing homeownership opportunities and ensuring a safe and decent living environment for all Americans. Although we certainly agree that spending cuts are a necessary component of an overall deficit reduction plan, we must question those proposed solutions that would feature a disproportionate share of cuts for housing as opposed to other budgetary items. The budget authority of the Department of Housing and Urban Development has already been reduced by more than 50 percent since 1980.

In this context, there are specific elements of the Administration's current budget proposals which we are unable to support. In particular, we would urge your opposition to:

- Increased fees on loans guaranteed through the Veteran's Administration and loans insured through the Federal Housing Administration.

- The imposition of fees on all borrowings and mortgage-backed securities issuances of the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation.

- The proposed increase in the fee charged to mortgage-backed securities issuers by the Government National Mortgage Association.

If implemented, these proposed higher fees and charges will only exacerbate the nation's already critical housing affordability problem, and will be particularly detrimental in California where housing prices average over 50 percent higher than in the rest of the country. In the present climate with mortgage interest rates still very high by historical standards, many households--particularly first-time homebuyers--face great difficulty in purchasing housing. Further, recent disruptions to the mortgage insurance industry have caused these private firms to cease offering the 90 and 95 percent financing that most first-time buyers depend upon. Reducing the availability of FHA and VA financing opportunities--the only other source of this financing--thus disproportionately impacts upon younger households seeking to make their first home purchase.

The federal housing credit agencies have been especially important in California, and any impairment of their operations would adversely affect housing in the state. Moreover, since housing produces significant stimulous to the general economy, any decline in housing construction and sales activity would have further adverse economic consequences, even beyond the readily apparent direct impacts.

Finally, these proposals, if adopted, would represent a fundamental reversal in our nation's commitments to housing and would undermine homeownership opportunities for thousands of households in this country. The consequences of the housing affordability problems are already evident: According to the Census Bureau, between 1980 and 1983 the proportion of Americans who own their own home declined 1 percent--the first decline in 20 years. Given the ongoing and very real affordability problems faced by homebuyers, the justification for maintaining the existing federal credit support of housing has never been greater.

For all these reasons, we strongly urge that any proposals to increase user-fees on federal housing credit programs be reconsidered and that housing's priority as a national objective be reflected in any final Budget Resolution.

We thank you for providing the opportunity for the Association to express these views.

Consortium for
Citizens with
Developmental
Disabilities

March 4, 1985

The Honorable Pete V. Domenici
Chairman
Senate Budget Committee
U.S. Senate
621 DSOB
Washington, DC 20510

Dear Senator Domenici:

We are aware that the Senate Budget Committee is currently reviewing President Reagan's FY 1986 budget in preparation for the development of the First Concurrent Budget Resolution. Therefore, we wanted to share with you our views on one aspect of the President's budget request -- the federal-state Medicaid program.

As a coalition of national organizations interested in the welfare of severely disabled children and adults, we are vitally concerned that the funding level for the Medicaid program be maintained. Hundreds of thousands of developmentally disabled persons rely on Medicaid payments to cover the cost of the health and health-related services they require.

We would appreciate it if the statement accompanying this letter would be included in the Committee's deliberations on the FY 1986 budget resolution.

Sincerely,

Robert M. Gettings

RMG:lab

On behalf of:
    National Association of State Mental Retardation Program Directors;
    National Association of Private Residential Facilities;

National Mental Health Association;
International Association of Psycho-Social Rehabilitation Services;
National Easter Seals Society;
National Society for Autistic Children;
United Cerebral Palsy Associations;
National Association of Protection and Advocacy Systems;
American Association of Mental Deficiency;
National Head Injury Foundation
National Alliance for the Mentally Ill
American Speech-Language-Hearing Association

Statement

Respectfully Submitted

to the

House Budget Committee

and the

Senate Budget Committee

on behalf of

- National Association of Private Residential Facilities for the Mentally Retarded, Inc.
- National Mental Health Association
- International Association of Psycho-Social Rehabilitation Services
- National Easter Seals Society
- National Society for Autistic Children
- United Cerebral Palsy Association
- National Association of Protection and Advocacy Systems/ American Association on Mental Deficiency
- National Head Injury Foundation
- National Alliance for the Mentally Ill
- American Speech-Language-Hearing Association
- National Association of State Mental Retardation Program Directors

The Consortium for Citizens with Developmental Disabilities (CCDD) represents 40 national organizations interested in the welfare of children and adults with severe, continuing disabilities originating in childhood. The Consortium's Task Force on Medicaid is concerned specifically with those aspects of the federal-state Medicaid Assistance program which impact on the capability of states and private providers to furnish appropriate, high quality services to Title XIX-eligible developmentally disabled children and adults. As such, the organizations represented on the Task Force are vitally interested in proposed statutory revisions to Title XIX of the Social Security Act which the Administration plans to have introduced in the next few weeks. Since the Committee is currently engaged in reviewing the President's FY 1986 budget, in preparation for development of the First Concurrent Budget Resolution for FY 1986, the Task Force would like to share with members of the Committee its views on several aspects of the proposed Medicaid revisions which are incorporated in President Reagan's FY 1986 budget estimates.

Under current law aggregate Medicaid outlays for all purposes are expected to increase by $1.7 billion between FY 1985 and FY 1986 (or by approximately 7.4 percent). The Administration, however, is proposing legislative changes to limit program outlays by approximately $1.0 billion in FY 1986 and by a total of

$16.6 billion over the next five years. These savings would be achieved by limiting federal Medicaid expenditures to $22.2 billion in FY 1986, compared to the estimated $23.5 billion required under current law. In addition, the growth in federal expenditures in future fiscal years would be restricted to inflationary adjustments, as measured by the Medical Care Component of the Consumer Price Index. Within this overall spending ceiling, each participating state would be entitled to receive the same proportional share of federal funds as it expended in FY 1984. The effect of the Administration's proposal amounts to negative growth in federal aid, at a time when the number of people expected to receive Medicaid benefits is increasing. The impact of the proposal, therefore will have dramatic consequences for the portion of the American population most in need of Medicaid services.

CCDD opposes the Administration's plan to place a ceiling on future federal Medicaid outlays for the reasons stated below:

A. The imposition of a cap would place a disproportionate share of the burden of reducing the federal deficit on millions of poor, elderly and disabled persons who represent the most vulnerable segment of American society. Included in the number of individuals currently receiving Medicaid benefits are thousands of mentally disabled, severely, physically handicapped, and mentally retarded and other developmentally disabled persons who have few, if any, alternative sources of income and, limited capability for gainful employment. The "constrained growth" posture advocated by the Administration in reality represents a callous attempt to renege on the federal government's long standing commitment to share in the cost of furnishing health and health-related services to low-income Americans. A ceiling, or cap, on federal financial participation would merely shift the burden increasingly to state and local government and private, charitable organizations. Fewer federal dollars and an increased number of beneficiaries would necessitate spreading already limited resources even thinner. Disabled recipients would be particularly vulnerable to reduction in Medicaid benefits that almost inevitably would occur, since this group of recipients, existing statistics suggest, have less income and tend to remain on the benefit rolls for longer periods, compared to other Medicaid recipients, due to their severely impaired earning capacity.

B. The Administration's proposal to cap federal Medicaid outlays would lock into place existing interstate inequities in federal aid for health and health-related services to Medicaid-eligible recipients. Under the Administration's proposal state shares of the Medicaid "pie" would be determined by a proportional formula based on FY 1984 spending. Each state would receive the same proportion of the $22.2 billion in FY 1986 (and future fiscal years) that it received in FY 1984. According to 1983 data, three states received 36 percent of all federal Medicaid payments, while the top 10 states received nearly two-thirds of all federal Medicaid dollars.[1] As a result, access to appropriate health care services for needy Americans varies widely from state-to-state. These variations would be unconscionably frozen in place should federal participation in the program be capped.

C. A cap on future federal Medicaid outlays would discourage the development of less costly alternative community-based services by effectively freezing new recipients out of the program and limiting states' ability to provide appropriate forms of care. Since 1981, with the development of the Medicaid home and community-based care waiver program, it has been demonstrated that states can successfully prevent unnecessary admissions to costly institutional care by developing appropriate home and community based programs.

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[1] 1983 data from the Medicaid Statistics Branch of the Department of Health and Human Services, based on information submitted by the Health Care Financing Administration in a letter dated November, 1984.

In effect, If the Administration's proposal were accepted, the fiscal burden of providing health and health-related care to newly eliglbe recipients would have to be borne entirely by state and local governments.

Members and staff of the organizations represented on the Task Force will greatly appreciate your consideration of these comments in the Committee's budget deliberations.

TESTIMONY

TO

SENATE COMMITTEE ON THE BUDGET

MARCH 5, 1985

SUBMITTED BY:

DEANNA CHESHEWALLA, CHAIRPERSON
BOARD OF DIRECTORS
DALLAS INTER-TRIBAL CENTER
209 E. JEFFERSON BLVD.
DALLAS, TEXAS 75203-2690

My name is Deanna Cheshewalla. I am the chairperson of the board of directors of the Dallas Inter-Tribal Center, Inc., a comprehensive urban Indian health organization incorporated in 1971, to address the health needs of the 20,000 Indians living in Dallas and the surrounding 11 county area.

I am submitting this written testimony to urge the reauthorization of bill S-277 (The Indian Health Care Improvement Act) and for continued appropriations for urban Indian health care. In 1964, Congress, as a matter of public policy, declared this nation's intent to "eliminate poverty in the midst of plenty." In 1976, Congress passed the above mentioned act. In 1980, this act was reauthorized and it reaffirmed the government's commitment to help Indians, whether on reservations or in urban areas (Title V of the Act), to acquire health care that would eventually allow them to obtain a health status on a parity with the general American population. Even though this bill passed both houses of Congress in 1985, it was vetoed by the President. However, through the Continuing Resolution, these urban Indian health programs are funded through September, 1985. These declarations recognized that poverty and ill health are in concert and that national effort must be undertaken to eradicate both if Native American Indians are to improve the quality of their existence and to gain access to the abundant prosperity generally available to the U.S. population. While progress has been made (dramatic declines have been reported in the incidence of tuberculosis, infant mortality, chronic anemia, and malnutrition), still a disproportionate number of Indian people suffer from diabetes; heart disease; high blood pressure; upper respiratory infections, such as ear infections, colds and flu; and from dental problems. Studies continue to report the Native American Indian, based on any measure of income, educational attainment, employment, housing conditions, or health status is the most isolated, underserved, and deprived group in this country.

Texas, according to the 1980 Census, has an Indian population of 40,440. In 1970, the Census reports 17,957. Texas Indian communities estimate closer to 70,000, unofficially. Whatever the actual figures, Texas has the ninth largest Indian population in the United States. This state has two reservations. But these reservations, which are only state recognized, are home for only 859 or 2.1% of the state's Indians. Most live in cities or rural areas. The Dallas/Fort Worth area is home to approximately 20,000 or 49.5% of these off-reservation Indians. A survey completed by this center in 1977-78 showed that 48.2% of the area Indian population has migrated here since 1957, when the Bureau of Indian Affairs opened a field employment placement office in Dallas. While that office closed in September, 1980, Indian people continue to migrate to the Dallas area.

Data taken from a status report done by the Texas Indian Commission in 1983, shows the following statistics for the Dallas/Fort Worth metroplex Indian community: The average family size is 3.9, the median family income is $7,000 annually, 53% of the population is at or below poverty level, 45.6% of the population is unemployed, 25% of the population lives in substandard housing, and the median education level is 11.2 years. Of 1984 Dallas Inter-Tribal Center medical users, 65.7% are under 20 years of age, 21.4% are 20-34, 5.6% are 35-64, and .8% are 65 years old or older. In 1984, 2,835 new patients were seen in our medical and dental clinics.

For Dallas area Indians, the essential support system used in making the difficult transition from reservation to urban life is the Dallas Inter-Tribal Center. This program is the "safety net" for these people.

Since 1971, the Dallas Inter-Tribal Center, Inc., has made a determined effort to mitigate the barriers that keep Indians from receiving social, economic, employment, educational, and health services in the city. While primarily funded to provide ambulatory health care services, the center recognizes that the absence of disease or infirmity does not. in itself. constitute a healthy person or population. Health is also a state of social and economic well being. Most of the clients who use the center are also suffering the consequences of legal disfranchisement and other problems arising out of the social fabric of the environment. Burdened with the inability to cope with feelings of hopelessness and despair. dependence and inferiority. the urban Indian is not as well prepared psychologically or vocationally for existence in the urban oriented 20th Century as is the general population. This quality of life carries over directly into a disproportionate amount of emotional and health problems such as depression. personality disorganization. alcoholism. suicide. and disease.

The proper approach in attacking these problems involves more than medical treatment of the symptoms. Because the roots of these problems are in the complex interaction of biological. social. cultural. and environmental factors. the solutions cannot be approached in a narrow technological way. but require a health system which can provide human support in other areas as well.

Through its programs. the Dallas Inter-Tribal Center attempts to erase the painful and difficult transition from endless years of reservation dependence to life in the city. Those services include medical. dental. health/nutrition education. WIC. eyeglasses and clothing services. transportation. referrals. medical follow-up. alcoholism counseling. Indian child welfare services. and home visits.

% Services Increase/Decrease
%IHS Funding Increase/Decrease

Year	% Service +/-	% IHS Funding +/-
1979-1980	+ 75.2%	+ 10.1%
1980-1981	+ 69.0%	+ 11.1%
1981-1982	+ 5.0%	+ 2.0%
1982-1983	+ 36.7%	- 13.1%
1983-1984	+ 2.0%	+ 3.7%
1974-1984	+802.3%	+356.4%

The success of the Dallas Inter-Tribal Center in impacting the severity of these problems. the recognition that the services are cost effective [$14.26 per encounter compared to $40-$45 in the private sector]. the realization by other human service providers that only the Dallas Inter-Tribal Center can effectively address this need for Indian people in Dallas. and that city and state resources are unable to absorb costs for these services are all documented in our reports to our funding agencies.

Without Title V dollars for health care. Indians will have to return to the reservations for care. In Dallas. private physicians refuse to see clients on medicaid because the reimbursement rate does not reasonably cover costs. The city claims it does not have revenue to absorb the loss in federal support to community health centers and the state believes that it must maintain those programs it already supports through the block grant plan. Reservations. already overburdened. are not accessible. the closest PHS-IHS hospital being in Lawton. Oklahoma. approximately 200 miles away. In region seven. the four urban Indian health programs have submitted over 200 applications to the private sector and private foundations for health care funding support. Not one application has received an affirmative response. There just are no alternatives to the maintenance of the federal support for urban Indian health care at this time.

The Dallas Inter-Tribal Center has received health care dollars from Indian Health Service since 1974. From that period to 1984, the services have increased by 802.3%, while IHS funding increased by only 358.4%. From 1980 through 1984, services increased by 147.4%, while IHS funds remained essentially the same.

This adminstration has proposed the "safety net" theory in the belief that the underprivileged should not suffer unfairly in the cutting of waste in the government programs. This concept must include Title V funding programs for two reasons: (1) It is more cost effective to maintain this proven system for health care delivery than to disrupt that system, in so doing, to create an additional burden on local health services when those resources are also being cut back under block grants and medicaid. (2) It is more humane to maintain the gradual improvement in the health of the Indian population than to lose those gains immediately, and then, in the future, have to develop yet another system when it is clear that the local resources cannot absorb the demand for such care.

If the "safety net" theory is to be protective and supportive of Indian people, then the President and Congress must clearly understand: That an Indian continues to struggle to acquire basic human needs satisfaction (biological and psychological: safety, food, housing, employment, acceptance) while the majority of the population has already acquired those basics and is directed towards the more human pursuits (personal growth, meaningfulness, competence, advancement, self-actualization); that this country, which holds out to the world its benevolence, must, as a society, also foster the fullest development of human potentials for all its own peoples.

The paradox of Indian poverty and ill-health in the midst of plenty is a travesty. The Indian has briefly and barely tasted some of the fruits of this abundance, but will not easily return to a fruitless existence. When you are at the bottom of the totem pole, there can be no way but up. To expect the Indian to be satisfied with less is wholly unreasonable in the 20th Century.

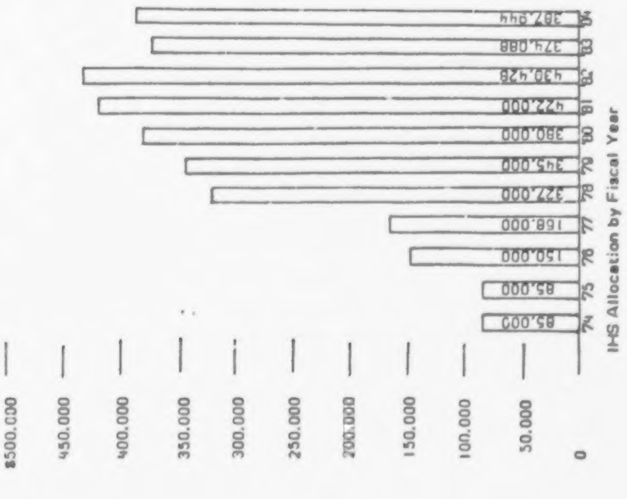
Without continued federal support to provide access to better health care and therefore a better life, the urban Indian truly remains the unwilling prisoner of an inhumane society.

I urge you, in the interests of this country and the people I represent, to continue the improving relationships between the government and the Indian by remaining directly involved and responsible for the provision of health care and other desperately needed support services so that the First Americans can also become first class Americans with all that entails.

You can accomplish this by reauthorizing the Indian Health Care Improvement Act and appropriating $12 million for urban Indian health programs.

Thank you.

Deanna Cheshewalla


$500,000
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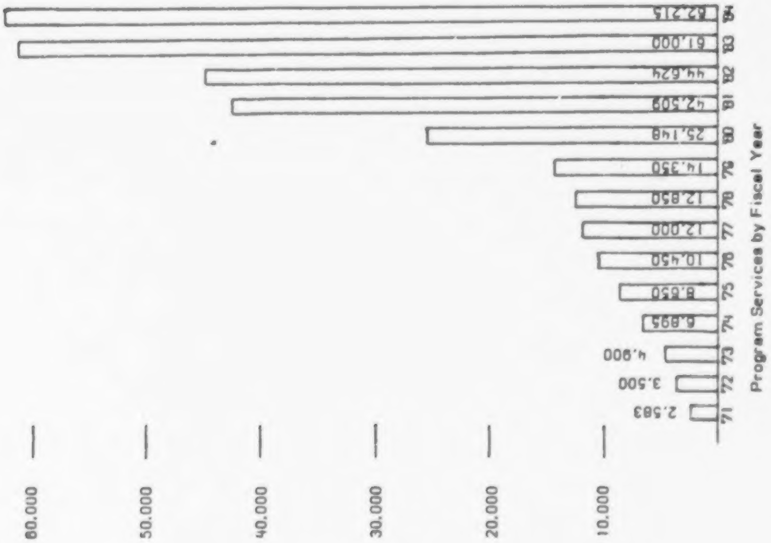
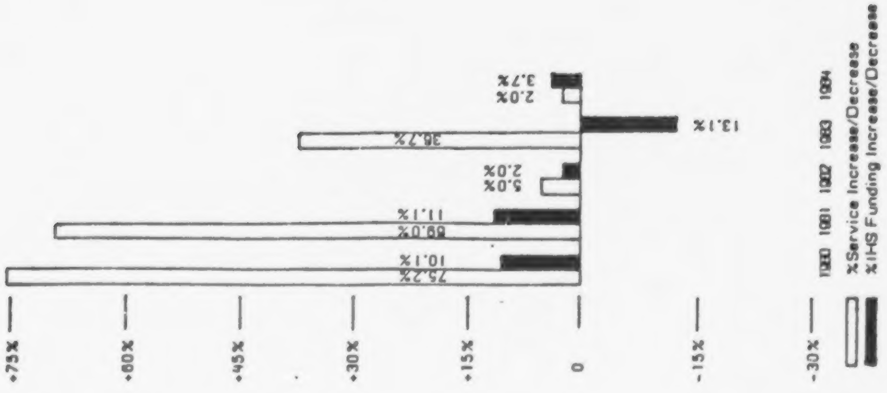
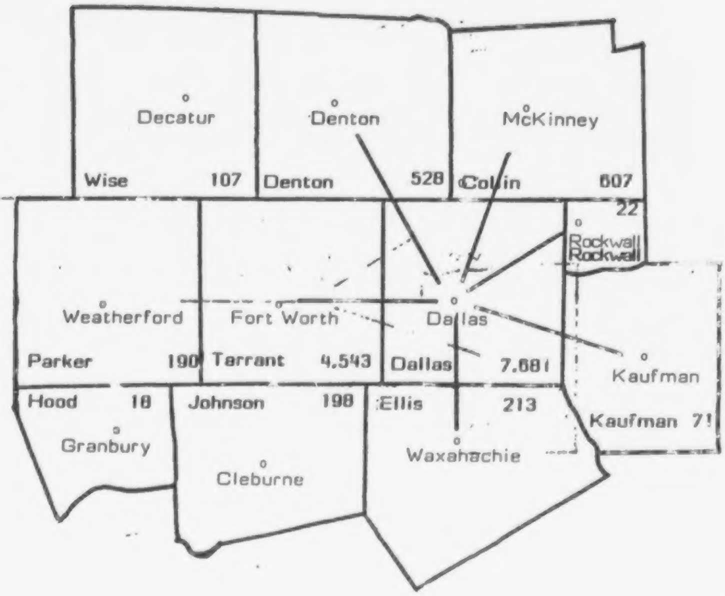
74 85,000
75 85,000
76 150,000
77 168,000
78 327,000
79 345,000
80 380,000
81 422,000
82 430,428
83 374,088
84 387,944
IHS Allocation by Fiscal Year


60,000
50,000
40,000
30,000
20,000
10,000
71 2,583
72 3,500
73 4,900
74 6,895
75 8,650
76 10,450
77 12,000
78 12,850
79 14,350
80 25,148
81 42,509
82 44,624
83 61,000
84 62,215
Program Services by Fiscal Year


+75%
+60%
+45%
+30%
+15%
0
-15%
-30%
1980 75.2% 10.1%
1981 69.0% 11.1%
1982 5.0% 2.0%
1983 36.7% 13.1%
1984 2.0% 3.7%
%Service Increase/Decrease
% IHS Funding Increase/Decrease



DALLAS INTER-TRIBAL CENTER
CATCHMENT AREA

Figures are taken from the 1980 Census of Population and Housing. Total 14,178

[illegible] Executive Secretary Treasurer

RLEA

RAILWAY LABOR EXECUTIVES' ASSOCIATION

RAILWAY LABOR BUILDING, 400 1st ST., N. W., WASHINGTON, D. C. 20001

February 25, 1985

Honorable Pete V. Domenici, Chairman
Committee on the Budget
434 Dirksen Building
Washington, D. C. 20510

Dear Mr. Chairman:

The railroad workers and retirees are fully aware that you and your Committee have a tremendous job in trying to arrive at a fair, reasonable and effective budget that would begin on October 1, 1986 as almost all of the people in our society are affected one way or the other under the Administration's budget.

Our major concern is the complete discontinuance of the Amtrak System. Listed below are some of our main reasons why the Amtrak System should be kept intact as much as possible:

(1) There would be an estimated loss of 25,000 jobs through the discontinuance of Amtrak. The Railroad Retirement Board has given me information that the income to the Railroad Retirement Account would decrease by about $150 million per year between 1986 and 1990.

(2) The balance of the Railroad Retirement Acount will be about $3.9 billion less by December 1, 1990 if the jobs are lost than if they are not lost. By any standard, this is a major loss of revenue.

(3) Unemployment and sick insurance payments will increase by about $110 million in fiscal 1986 and by about $60 million in fiscal year 1987. This large increase in benefits payment would be incurred just as the Railroad Retirement Unemployment Insurance Account loses its authority to borrow from the Railroad Retirement Account. In the absence of corrective unemployment insurance legislation by September 30, 1985, the loss of Amtrak jobs will cause serious problems in the timely payment of unemployment and sick benefits.

ONE YEAR TIER II COLA FREEZE ON RAILROAD RETIREMENT ANNUITIES PROPOSED IN THE BUDGET

We are somewhat disappointed that the President's budget contained a recommendation to place a one year COLA freeze on Tier II benefits on Railroad Retirement annuities. I must call your attention to the fact

[illegible] Association, Division of BRAC • American Train Dispatchers Association • Brotherhood of [illegible] Engineers • Brotherhood of [illegible] Signalmen • Brotherhood of Railway Airline and Steamship Clerks, Freight Handlers, Express and Station Employes • [illegible] Employees International Union • International Association of Machinists and Aerospace Workers • International Brotherhood [illegible] • International Brotherhood of Electrical Workers • International Brotherhood of Firemen and Oilers • [illegible] of America • Seafarers International Union of North America • Sheet Metal Workers International Association • Transport Workers [illegible]

that at the request of the Committees that handle Railroad Retirement, an agreement was worked out to put our retirement system on a sound financial funding basis. Part of this agreement provided for only a cent and a half COLA effective January 1, 1985. Without a doubt, the railroad retirees feel they have paid the price and have contributed toward keeping the fund on a sound financial basis. It would be appreciated if your Committee would remove this recommendation from the 1986 Budget. These funds are not taxpayers funds, but employees and employers funds.

In the event all pension plans such as Social Security, Civil Service, Military, private, etc. are required by Congress to take a one year deferral in the COLA, then, certainly, we, as railroad workers, would cooperate and take a strong look at it if and when that is done.

Your cooperation will be greatly appreciated by all concerned.

Respectfully,

Jim Snyder

J. R. (JIM) SNYDER, Chairman
Legislative Committee, R.L.E.A.

cc: Members, Senate Budget Committee

RAILWAY PROGRESS INSTITUTE

WILLIAM R. GALBRAITH, CHAIRMAN • GLENN E. STINSON, VICE CHAIRMAN • ROBERT A. MATTHEWS, PRESIDENT

POLICY STATEMENT
OF THE
RPI COMMITTEE ON PASSENGER TRANSPORTATION

The need to meet the growing Federal budget deficit problem has become increasingly clear. We recognize that fact and fully endorse equitable, across-the-board efforts to reduce the nation's budget deficit.

The Administration's budget requests nearly a $3.8-billion reduction in budget authority from the 1985 level for transportation programs. However, more than 83 percent of that reduction would come from the Urban Mass Transportation Administration's mass transit programs and the elimination of Amtrak's intercity rail passenger service.

The Railway Progress Institute is the association of suppliers to rail systems.

We private-sector suppliers to the rail passenger industry call attention to the following facts:

I. The Administration's transportation budget proposal represents an abrupt, arbitrary reversal of national policy. It would impede economic growth and employment opportunities in urban and rural America.

II. The budget proposal would result in the disruption of the nation's transit infrastructure and it would cause Amtrak to disappear into bankruptcy. This would throw away $10-billion of Federal investments in Amtrak, and between $25- and $30-billion in transit investments made over the past 20 years alone. Twenty percent of the transit systems would be forced to consider shutting down. Requisite maintenance would be deferred or eliminated. Service would deteriorate. The mobility of many of the nation's citizens would be reduced. Prior capital investments would be wasted. Plans for new urban rapid transit systems would be abandoned and expansions of existing systems would be eliminated.

III. The Administration's budget, if approved, would mean massive negative impacts on our industry -- if not its total elimination. This puts more than 250,000 taxpaying jobs dependent upon surface passenger transportation at risk, as well as substantial investments in research, development, and manufacturing facilities. A loss of $10-billion in direct private business revenues

Representing the Rail Equipment and Supply Industry
700 North Fairfax Street, Alexandria, Va. 22314-2098
703-836-2332

is likely, and this grows to $25-billion when multipliers derived from the U.S. Department of Commerce's input-output studies are applied.*

The Administration has proposed a deficit reduction plan in which virtually all reductions come from cuts in non-defense domestic spending programs. In the transportation sector, virtually all of the reduction comes at the expense of transit and rail passenger service.

In its search for a quick fix to the deficit problem, the Administration has developed a proposal with disastrous long-term impacts. To achieve a $3-billion short-term saving, more than $10-billion in annual industry revenues will disappear and the mobility of America will be severely curtailed.

We urge the Congress to reject the Administration's transportation proposal and develop a deficit reduction program that is fair, equitable, and across-the-board.

---

*These multipliers are 2.36 for subway construction, 2.6 for railcar manufacturing, and 2.61 for bus manufacturing.

3/6/85

RPI Committee on Passenger Transportation

Transit America Inc.
Philadelphia, PA

General Railway Signal Company
Rochester, NY

Bachman Associates
Alexandria, VA

Bombardier, Inc.
Boucherville, Quebec
CANADA

CF&I Steel Corporation
Pueblo, CO

General Electric Company
Erie, PA

Maurice Pincoffs Company, Inc.
Houston, TX

Transportation Technology
Annandale, VA

General Motors Corporation
LaGrange, IL

Mass Transit, Inc.
Washington, DC

De Leuw, Cather & Company
Washington, DC

Dayco Corporation
Dayton, OH

American Standard, Inc.
Pittsburgh, PA

Thrall Car Manufacturing Company
Chicago Heights, IL

The Ohio Brass Company
Mansfield, OH

The TGV Company
Washington, DC

Pullman Technology, Inc.
Downers Grove, IL

C&S Transit Corporation
Chesapeake, VA

Pittsburgh Spring, Inc.
Pittsburgh, PA

Knorr-Brake Corporation
Rockville, MD

Alsthom Atlantic, Inc.
New York, NY

Accurate Bushing Company
Garwood, NJ

American Standard, Inc.
Wilmerding, PA

Dellner Couplers, Inc.
Bridgeport, CT

Speno Rail Services Company
East Syracuse, NY

Hughes Railway Supplies
Philadelphia, PA

Westcode, Incorporated
Frazer, PA

TransTech, Inc.
East McKeesport, PA

Vapor Corporation
Chicago, IL

Morton Manufacturing Company
Libertyville, IL

PTJ Publishing, Inc.
Homewood, IL

Westinghouse Electric Corporation
West Mifflin, PA

Pettibone Corporation
Chicago, IL

M. B. Mitchell & Associates, Inc.
McLean, VA

The Timken Company
Ft. Washington, PA

Chrysler Corporation
Washington, DC

Ogontz Corporation
Willow Grove, PA

Portec, Inc.
Oak Brook, IL

Metro Magazine
Redondo Beach, CA

New York Air Brake Company
Watertown, NY

Safetran Systems Corporation
Louisville, KY

Henry Miller Spring & Mfg. Co.
Park Ridge, IL

Sumitomo Corporation of America
New York, NY

Faiveley Corporation
Somerset, NJ

Unity Railway Supply Co., Inc.
Bensenville, IL

Alco Spring Industries, Inc.
Chicago Heights, IL

Norman W. Seip & Associates
Erie, PA

Abex Corporation
Chicago, IL

Comstock Engineering, Inc.
Chamblee, GA

Lukens General Industries
St. Louis, MO

Monogram Industries, Inc.
Redondo Beach, CA

Servo Corporation of America
Hicksville, NY

UTDC (USA), Inc.
Detroit, MI

The Railroad Retirement Association
210 7th Street, S.E., Suite 517
Washington, D.C. 20003
(202) 546-5856

STATEMENT
OF
THE RAILROAD RETIREMENT ASSOCIATION
TO
THE BUDGET COMMITTEE
OF
THE UNITED STATES SENATE
ON
THE FISCAL 1986 BUDGET

THIS ASSOCIATION IS INCORPORATED AS A NON-PROFIT, NON-STOCK INDIVIDUAL MEMBERSHIP ASSOCIATION UNDER THE NON-PROFIT CORPORATION CODE OF OF THE DISTRICT OF COLUMBIA.THE ASSOCIATION IS NOT IN ANY WAY AFFILIATED WITH ANY ELEMENT OF THE RAILROAD INDUSTRY NOR WITH ANY ELEMENT OF THE STANDARD RAILROAD LABOR ORGANIZATIONS.THE ASSOCIATION IS DESIGNED, ORGANIZED AND STRUCTURED TO BE GOVERNED BY AND FOR, AND TO SERVE THE INTERSTS OF, ONLY INDIVIDUALS WITH VESTED RIGHTS IN THE RAILROAD RETIREMENT SYSTEM, CURRENT BENEFICIARIES AS WELL AS INDIVIDUALS WITH VESTED RIGHTS TO BE EXERCISED IN THE FUTURE.

THE JANUARY 1985 CONGRESSIONAL RESEARCH SERVICE (CRS) REPORT TO YOUR COMMITTEE,ENTITLED " FINANCING WORK-RELATED ENTITLEMENT PROGRAMS: AN UPDATE",CONTAINS,IN CHAPTER 5, AN EXCELLENT EXPLANATION OF THE RAILROAD RETIREMENT SYSTEM (RRS) AS IT IS STRUCTURED TODAY.

RRS AND SOCIAL SECURITY (SS) WERE COORDINATED BY AN 1951 LAW WHICH ESTABLISHED THE " FINANCIAL INTERCHANGE " BETWEEN RRS AND SS AND MADE IT RETROACTIVE TO JANUARY 1, 1937. IT WAS MADE RETROACTIVE TO JANUARY 1,1937 SO AS TO PUT THE SS TRUST FUND IN THE SAME POSITION AND CONDITION AS IT WOULD HAVE BEEN IF RAILROAD EMPLOYMENT HAD BEEN COVERED UNDER THE SS ACT FROM THE START OF SS. THE NECESSARY COMPUTATIONS WERE MADE AND THE SS FUND WAS PUT IN THE SAME POSITION AND CONDITION AS IT WOULD HAVE BEEN IF RAILROAD EMPLOYMENT HAD BEEN COVERED BY SS FROM THE START, BACK TO JANUARY 1,1937.

THE 1973-74 LAWS RESTRUCTURING RRS SEPARATED THE RRS BENEFIT INTO TWO COMPONENTS: TIER I AND TIER II.AS THAT CRS REPORT STATES: " TIER I BENEFITS ARE SIMILAR TO SOCIAL SECURITY AND TIER II BENEFITS CONSTITUTE AN INDUSTRY PENSION."

THEREFORE, ALL RAILROAD WORKERS AND THEIR EMPLOYERS HAVE PAID THEIR FULL SS TAXES, AND EVERY RAILROAD RETIREE IS ALSO AN SS RETIREE AND HAS FULL STANDING AS SUCH.THEIR PLIGHT AS OLDER AMERICANS AND AS SOCIAL SECURITY RECIPIENTS, THE BENEFIT REDUCTIONS THEY HAVE ALREADY SUFFERED AS SOCIAL SECURITY RECIPIENTS, AND THE IMPACT ON THEM OF TWO COLA-CUT PROPOSALS UNDER CONSIDERATION ARE FULLY AND ABLY DESCRIBED IN THE TESTIMONY OF CYRIL F. BRICKFIELD, EXECUTIVE DIRECTOR OF THE AMERICAN ASSOCIATION OF RETIRED PERSONS, PRESENTED TO YOUR COMMITTEE FEBRUARY 22ND. TO AVOID REPETITION THOSE POINTS ARE NOT BEING REPEATED IN THIS STATEMENT. THIS ASSOCIATION SUPPORTS THOSE PARTS OF THAT TESTIMONY.

RAILROAD RETIREES HAVE SUSTAINED BENEFIT REDUCTIONS AND INCREASED COSTS IN THE PRIVATE PENSION PORTIONS OF THEIR RRS BENEFITS IN ADDITION TO, AND ON TOP OF, THOSE AFFECTING THE SS PORTION OF THEIR BENEFITS.THOSE BENEFIT REDUCTIONS AND INCREASED COSTS WERE IMPOSED BY THE RAILROAD RETIREMENT SOLVENCY ACT OF 1983, (PUBLIC LAW 98-76), PASSED BY THE HOUSE AUGUST 1,1983 UNDER CLOSED-TYPE PROCEDURES AND BY THE SENATE AUGUST 2,1983 UNDER EXPEDITED PROCEDURES, ALL WITH THE APPROVAL OF, AND AT THE URGING OF OMB.OMB TOLD THE SENATE FINANCE COMMITTEE AT THE AUGUST 2ND MORNING HEARING THAT THE LEGISLATION WOULD TAKE CARE OF THE SOLVENCY PROBLEM OF THE RRS FUND FOR AT LEAST 6 YEARS AND THAT PASSAGE OF THE LEGISLATION WOULD MEAN THAT THE CONGRESS WOULD NOT HAVE TO DEAL WITH RRS EVERY YEAR OR TWO.

YET, NOW, LESS THAN TWO YEARS LATER, OMB RECOMMENDS ADDITIONAL AND FURTHER REDUCTIONS IN RRS PRIVATE PENSIONS AND INCREASED COSTS FOR RRS PRIVATE PENSIONERS, EVEN THOUGH, AS POINTED OUT IN THAT CRS REPORT TO YOUR COMMITTEE, RRS TIER II IS A PRIVATELY FINANCED SYSTEM AND " OTHER FEDERAL TAXPAYERS ARE NOT TO BE RESPONSIBLE FOR COSTS OF" THAT TIER II PRIVATE PENSION PORTION OF RRS.

TOO FREQUENTLY ONE HEARS COMMENTS TO THE EFFECT THAT RRS RETIREES ARE A PRIVILEGED RETIREE GROUP,THAT THEY RECEIVE HUGE RETIREMENTS AND THAT THEY RECEIVE MORE THAN THEY PAY FOR. NOTHING COULD BE FURTHER FROM THE TRUTH. FROM THE START OF RRS, RRS TAXES HAVE BEEN HIGHER THAN SS TAXES, 2.75PERCENT ON EMPLOYEES AND 2.75PERCENT ON EMPLOYERS UNDER THE 1937 LAW.THE SS STARTING RATE WAS 1.00 PERCENT AND 1.00 PERCENT,RESPECTIVELY, AND THE SS EARNINGS BASE WAS LOWER THAN THE RRS BASE.

THE TOTAL EMPLOYEE AND EMPLOYER RRS TAX RATE WAS INCREASED OVER THE YEARS:1946-7.00 PERCENT;1947-11.5 PERCENT;1949-51-12.0 PERCENT;1952-59-12.5 PERCENT; 1965-15.0 PER CENT;AFTER 1968- 9.5 PERCENT PLUS THE TOTAL SS RATE.

THE TOTAL SS RATE REMAINED AT 2.00 PERCENT THROUGH 1949;1959-5.0 PERCENT; 1966-8.4 PERCENT;1969-9.6 PERCENT.THE INCLUSION OF THE HOSPITAL INSURANCE TAX IN THE SS RATE STARTED IN 1966.

IN THE LABOR-MANAGEMENT AGREEMENTS INVOLVED IN THE 1973-74 LEGISLATION RESTRUCTURING RRS IT WAS AGREED THAT FROM THAT POINT ON RAIL EMPLOYEES WOULD PAY ONLY THE SS TAX, AND THE RAIL EMPLOYERS WOULD PAY THE SS EMPLOYER TAX PLUS ALL THAT PART OF THE TOTAL RRS RATE ABOVE THE TOTAL SS RATE.INITIALLY, THAT ADDITIONAL RRS RATE FOR RAIL EMPLOYERS WAS 9.5 PERCENT.RECENT LEGISLATION INCREASED THAT RATE, INCLUDING THE ACT OF 1983, AND THAT ADDITIONAL RATE FOR RAIL EMPLOYERS IS 13.75 PERCENT THIS YEAR.

ALSO, A TAX ON RAIL EMPLOYEES WAS RE-INSTATED IN 1981 AND INCREASED BY THE 1983 ACT. THIS YEAR THAT ADDITIONAL RRS TAX FOR RAIL EMPLOYEES IS 3.5 PERCENT IN ADDITION TO THE SS EMPLOYEE TAX.

THERE HAS NOT BEEN, AND THERE IS NOT NOW, A FREE RIDE FOR RAIL EMPLOYEES IN RRS. RAIL EMPLOYEES HAVE PAID THEIR WAY IN THE PRIVATE PENSION PORTION OF RRS AS WELL AS IN THE SS PORTION OF RRS.

AND ,THERE IS NO " BONANZA " IN RRS. THE TOTAL RRS BENEFITS(THE SS PORTION PLUS THE PRIVATE PENSION PORTION) PAID OUT BY THE RRS BOARD IN 1984 AVERAGED $643.18 MONTHLY.THE 1985 AVERAGE WILL BE ONLY SLIGHTLY HIGHER BECAUSE OF THE SECOND TIER II CUT JANUARY 1,1985.THE RRS BOARD ESTIMATES THAT THE PRIVATE PENSION PORTION OF RRS BENEFITS WILL AVERAGE $500 MONTHLY IN 1985. BY COMPARISON AND CONTRAST, THE FEDERAL CIVIL SERVICE PENSION WILL AVERAGE SLIGHTLY LESS THAN $1,000 MONTHLY.

IF THE NOW FAMOUS MARY COULD BE CALLED UPON TO COMMENT, HER QUERY WOULD PROBABLY BE: " WHERE IS THE BEEF ? WHERE IS THE BONANZA IN RRS ? "

RAIL RETIREES HAVE ALREADY SUFFERED DELAY IN THE COLA ON THEIR RRS PRIVATE PENSION (TIER II) AND REDUCTIONS IN THE AMOUNT OF THAT TIER II BENEFIT UNDER THE 1983 RAILROAD RETIREMENT ACT:

BENEFIT REDUCTION ITEM	TOTAL LOSS FOR RAIL RETIREES FY 1984-88 (IN MILLIONS)
1. TIER II COLA DELAY	1. $ 60
2. CUT IN AMOUNT OF TIER II BENEFIT BY AMOUNT OF 5 % COLA ON TIER I BENEFIT	2. 920
3. SUBJECTING TIER II INCOME TO FEDERAL INCOME TAX	3. 785
4. SUBJECTING " WINDFALL " BENEFITS TO FEDERAL INCOME TAX	4. 170
5. CUT BACK IN AMOUNT OF EARLY RETIREMENT BENEFITS	5. 150
	$ 2,085

THAT LOSS IN INCOME AVERAGES OUT TO ABOUT $400 PER YEAR PER RECIPIENT DURING THAT 1984-88 PERIOD AND THAT IS IN ADDITION TO THE THE LOSS THEY SUSTAIN ON THE SS PORTION OF THEIR RETIREMENT.

THE TIER II BENEFIT CUT WAS MADE IN TWO PARTS UNDER THAT 1983 LAW, THE FIRST CUT JANUARY 1, 1984 AND THE SECOND JANUARY 1,1985.RRS BOARD FIGURES SHOW THAT AFTER THE FIRST CUT THE TOTAL 1984 RRS BENEFITS (SS PORTION PLUS RRS PRIVATE PENSION PORTION) PROVIDED INCOME BELOW THE POVERTY LEVEL OF $4,980 FOR 35,190 ONE-MEMBER FAMILIES.THE TOTAL MONTHLY BENEFIT AVERAGED $342.01 FOR THAT GROUP IN 1984.

FOR 91,128 ONE-MEMBER FAMILIES THOSE TOTAL RRS BENEFITS IN 1984 PROVIDED INCOME BELOW 125 PERCENT OF THE POVERTY LEVEL.THEIR MONTHLY BENEFIT AVERAGED $423.52 IN 1984.

THE SECOND CUT INCREASED THE NUMBER OF ONE-MEMBER FAMILIES IN THE FIRST GROUP TO 38,059 IN 1985 AND THE SECOND GROUP TO 102,790 ONE-MEMBER FAMILIES.

FOR ONE CATEGORY OF TWO-MEMBER FAMILIES THE TOTALS WERE 28,405 IN 1984 AND 30,921 IN 1985 BELOW THE POVERTY LEVEL, AND 60,588 AND 62,715, RESPECTIVELY, BELOW 125 PERCENT OF THE POVERTY LEVEL.

EVEN THOUGH THE TIER II COLA RATE WAS REDUCED TO ONLY 32.5 PERCENT OF THE TIER I COLA RATE SOME YEARS AGO, ANOTHER TIER II COLA DELAY WOULD CERTAINLY ADVERSELY AFFECT THOSE GROUPS.

OVER THE 1985- 2000 PERIOD THE PRE-1984 RAIL RETIREE GROUP WILL LOSE $2.311 BILLION IN TIER II BENEFIT INCOME, $1.622 BILLION BY THE FIRST CUT JANUARY 1, 1984, AND $689 MILLION BY THE JANUARY 1,1985 CUT.THE TIER II BENEFIT CUT PROVISIONS DO NOT APPLY TO ANYONE RETIRING AFTER DECEMBER 31,1983.

THE BUDGET PROPOSALS UNDER CONSIDERATION-(1) DELAY OF THE TIER II COLA,AND (2) THE INCLUSION AS PART OF TIER II FOR COLA CLASSIFICATION PURPOSES AND FOR PURPOSES OF DETERMINATION OF FEDERAL INCOME TAX LIABILITY AS TO TIER II THE PORTION OF A RETIREE'S TIER I BENEFIT WHICH IS IN EXCESS OF THE SOCIAL SECURITY BENEFIT TO WHICH THAT RETIREE WOULD BE ENTITLED UNDER THE SOCIAL SECURITY LAW-WOULD EXACERBATE THE INEQUITIES UNDER THAT 1983 LAW BY UNFAIRLY INCREASING THE BURDENS ON RETIREES.

EVEN IF ONE WERE TO SEE NO INEQUITY IN THE 1983 LAW,AND THERE ARE THOSE WHO FEEL THAT THAT 1983 LAW INVOLVED TRADE-OFFS, A BURDEN ON ONE AFFECTED GROUP AS A TRADE-OFF FOR THE BURDENS IMPOSED ON THE OTHER AFFECTED GROUPS,IT WOULD NOT BE FAIR TO ALTER THE EQUITIES BY SINGLING OUT THE ONE GROUP, THE RETIREES, FOR ADDITIONAL BURDENS AND LEAVING THE STATUS QUO UNDER THAT 1983 LAW AS TO THE OTHER AFFECTED GROUPS.

RAIL RETIREES WELCOME, IN FACT SEEK, A FULL RE-EXAMINATION OF THE EQUITIES OF THAT 1983 LAW BY THE CONGRESS.IT IS RESPECTFULLY SUBMITTED THAT THE RAILROAD RETIREMENT BUDGET PROPOSALS UNDER CONSIDERATION UNAVOIDABLY INVOLVE AND AFFECT THE EQUITIES OF THAT 1983 RAILROAD RETIREMENT LAW.

ALSO, PENDING BEFORE THIS CONGRESS FOR CONSIDERATION AND ACTION THIS YEAR IS THE JUNE 29,1984 REPORT OF THE LABOR-MANAGEMENT RAILROAD UNEMPLOYMENT COMPENSATION COMMITTEE ESTABLISHED UNDER THAT 1983 LAW.THE IMPLEMENTATION OF THE LABOR-MANAGEMENT RECOMMENDATIONS IN THAT REPORT WOULD REQUIRE SUBSTANTIVE CHANGES IN THAT 1983 RAILROAD RETIREMENT LAW.AT THE ONE HEARING HELD ON THAT REPORT LAST YEAR BY A HOUSE SUBCOMMITTEE AN OMB WITNESS TESTIFIED THAT THE LABOR-MANAGEMENT PROPOSAL IN THAT REPORT "IS NOT IN THE BEST INTEREST OF RAIL PENSIONERS",THAT THAT PROPOSAL " WOULD TAKE BETWEEN $.7 BILLION TO $2.9 BILLION FROM THE RAIL INDUSTRY PENSION FUND". THOSE RECOMMENDATIONS ALSO INVOLVE AND AFFECT THE EQUITIES OF THAT 1983 RAILROAD RETIREMENT LAW.

IT IS RESPECTFULLY SUBMITTED THAT ALL PROPOSALS INVOLVING AND AFFECTING THE EQUITIES OF THAT 1983 RAILROAD RETIREMENT LAW SHOULD BE CONSIDERED AS PART OF A FULL RE-EXAMINATION OF THE EQUITIES OF THAT 1983 LAW.

FEBRUARY 25,1985

RESPECTFULLY SUBMITTED,
L L Duxbury
L. L. DUXBURY
PRESIDENT

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VOLUME III TO FOLLOW